Behavioral finance in corporate governance: economics and ethics of the devil's advocate

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Abstract

The Common Law, parliamentary democracy, and academia all institutionalize dissent to check undue obedience to authority; and corporate governance reformers advocate the same in boardrooms. Many corporate governance disasters could be averted if directors asked hard questions, demanded clear answers, and blew whistles. Work by Milgram suggests humans have an innate predisposition to obey authority. This excessive subservience of agent to principal, here dubbed a "type II agency problem", explains directors' eerie submission. Rational explanations are reviewed, but behavioral explanations appear more complete. Experimental work shows this predisposition disrupted by dissenting peers, conflicting authorities, and distant authorities. Thus, independent directors,

chairs, and committees excluding CEOs might induce greater rationality and more considered ethics in corporate governance. Empirical evidence of this is scant—perhaps reflecting problems identifying genuinely independent directors.

Notes

1. See e.g. Laski (1919).

2. See e.g. Hermalin and Weisbach (2003) for a recent survey.

3. A large strategy literature posits behavioral regularities in boardrooms. For example Westphal and Stern 2006, 2007 and references therein demonstrate networking effects in director selection. Behavioral explanations of governance issues also enter the finance literature—e.g. Shleifer and Vishny (2003) on merger waves, Baker et al. (2007) on capital spending, Kindleberger (1978) on financial crises, and others.

4. See Bernardo and Welch (2001) for a discussion of group selection inducing seemingly irrational individual behavior in economics.

5. Such reflexive behavior is appreciated by students of marketing, such as Cialdini (1998), and motivates free samples and "no obligation" gifts as sales strategies.

6. This knowledge is used by, for example, professional pollsters to generate

answers that lend the aura of popular support to causes advanced by their clients (see Cialdini (1998)).

7. Shiller (1995) speculates, based on the anthropology literature, that compliance and herding echo social conventions of polite conversation that enhance group survival odds. Brown and Levinson (1987) argue that such aspects of conversational politeness are standard across cultures, and that real tolerance of dissent requires effort and challenges human nature.

8. Though see Leuz (2007).

9. See e.g. Hermalin and Weisbach (2003) for a recent survey.

10. See e.g. Lakonishok et al. (1992).

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