Behavioral Finance in Corporate Governance - Independent Directors, Non-Executive Chairs, and the Importance of the Devil's Advocate

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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 often 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.

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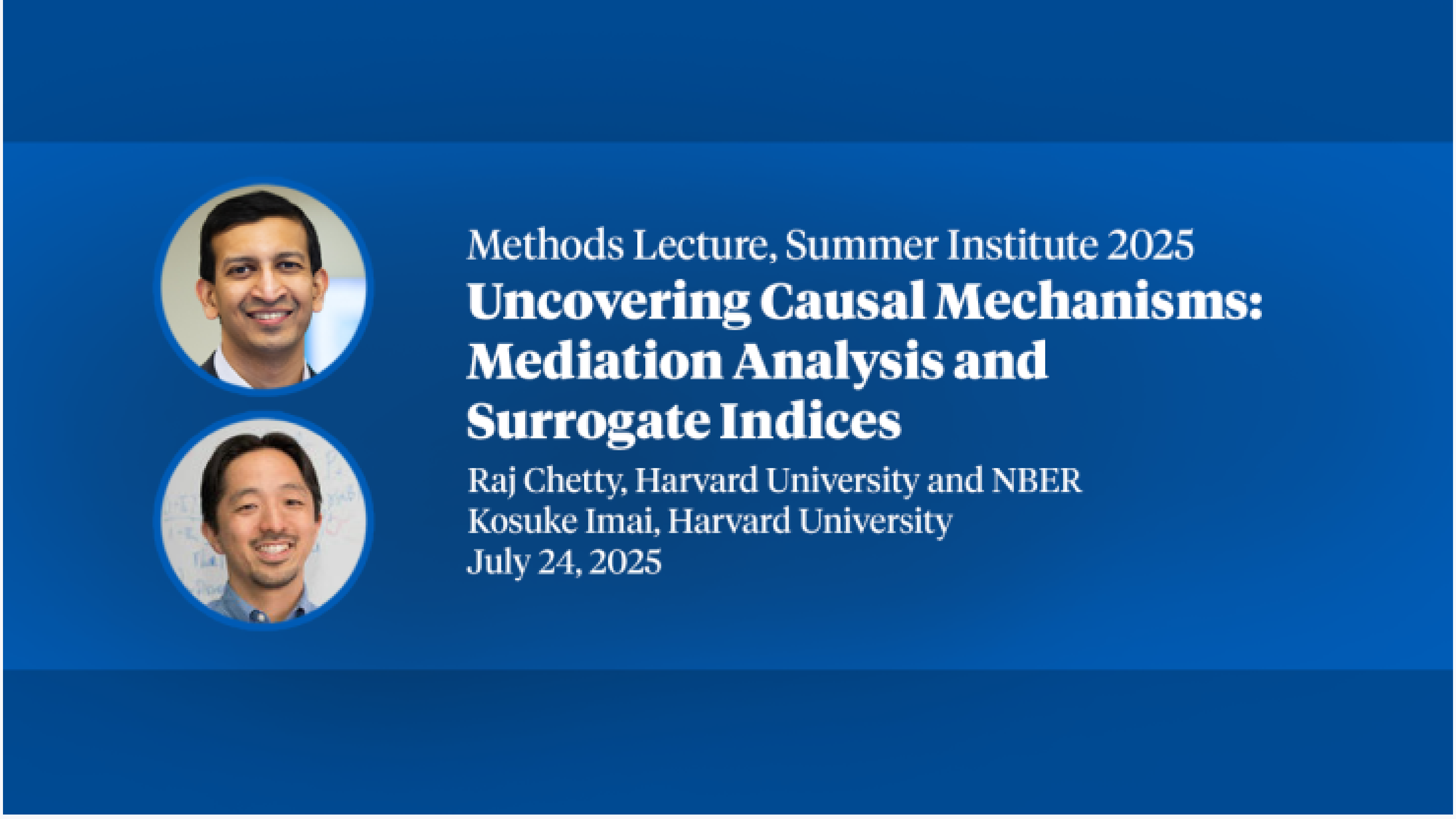

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