Invited comment on the consultation document of the

ICSA Review of the Higgs Guidance on behalf of the FRC - Improving board effectiveness.

(Second stage for consultation)

On the subject of decision making - Section 9

Key points

i. Bias in the boardroom is inevitable and underestimated

ii. Bias undermines the perceived benefit of independent directors

iii. Bias plays a significant role in poor board decision-making

iv. Governance regulation needs to highlight the effects of bias on decision quality

v. Guidelines should recommend the use of de-biasing procedures

Bias in the boardroom

This comment is informed by participant observer experience of the author of the governance failures of an organization that suffered significant adverse performance resulting in its near collapse. The author's experience mirrors research findings by Forbes and Watson (2010), who note that organizations characterised by "*strong managers and weak owners*" (Roe, 1994) expose themselves to "*destructive leadership*" risks (Padilla, et al., 2007) due to board loyalty biases, little mitigated by current corporate governance codes. This comment explores solutions to minimize bias in the boardroom to mitigate CEO destructive tendencies.

The paradigmatic approach to 'good' corporate governance for companies in terms of an overall focus on appropriate internal control and risk management procedures, places the responsibilities for such procedures firmly with the board, supported by a formal structure of board committees (Gwilliam and Marnet, 2010). In the wake of the high-profile corporate scandals earlier this decade, companies were required or encouraged to increase the percentage of independent directors on their board and increase the use of independent directors on board committees. Reflecting on the board's responsibilities, the Companies Act 2006 (UK, 2006) refers to the duty of directors to exercise independent judgment (Companies Act 2006 SS.173), while the ongoing Review (ICSA, 2010) of the Higgs Guidance on the role and effectiveness of non-executive directors (Higgs, 2003) notes the importance of the quality of board

decision-making and refers to a number of policies that can facilitate good decision-making.

However, calls for more diligent stewardship of the corporation would seem to increasingly necessitate a radical rethink of corporate governance principles and philosophy as past regulated increases in independent directors on boards and board committees have had little success in preventing subsequent failures in corporate governance. While existing corporate governance mechanisms and the market for corporate control would appear to eventually act to shield the majority of firms from the very worst consequences of poor executive decisions and failed monitoring by the board, this frequently occurs only after the destruction of significant corporate value.

In deriving a theory of governance based on incentives, disclosure and monitoring, the typical normative assumption in much corporate governance research is that of the self-interest of agents to guide their actions, protect shareholder's equity and act in their own best long-term interest. This approach has the flaw of being based on a poor model of human choice behaviour, a model which can be extended to provide for better descriptions of actual agent behaviour. This is, partially, being recognized by regulators and those tasked to improve on existing guidelines. The ICSA Review, for example, suggests that appropriate policies and processes to facilitate good decision-making, as suggested by the Higgs Guidance, are likely to be insufficient in the presence of behavioural factors that can lead to flawed decisions. The ICSA Review calls particular attention to the detrimental impact of social and psychological factors on the quality of boardroom decision-making. Recent high-profile corporate scandals and details emerging on the causes of the global financial crisis reinforce the impression that independent judgement, constructive debate and challenge in the boardroom remain the exception.

Central to the scores of corporate disasters in recent years has been the failure of directors as monitors and gatekeepers. These scandals are typically seen as a problem of corruption. No doubt, this is part of the story. But the bigger story is one of psychological bias. In the vast majority of cases of poor corporate performance, the root cause of poor-decision making may reside in persistent psychological and cognitive factors on the boardroom. Biased decisions are suggested to be a major contributing factor to what ultimately is seen as fraudulent, imprudent and/or destructive behaviour of executive management and the acquiescence (or mental blindness) to such activities by the board (and other gatekeepers). It will come as no surprise that people are biased by group loyalties, friendship, and non-pecuniary self-interest. Nevertheless, these potential sources of bias are frequently ignored or minimized by courts and standard setters who largely rely on the still dominant economic assumption that rational and competent individuals will make objective analyses and utilize all available information to ensure a best outcome for the firm remains.[1]

[1] For example, in a recent decision, the Delaware Supreme Court suggested that "most" friendships were not of a sufficiently "bias-producing nature" to negate a director's independence (Beam *ex rel*. Martha Stewart Living Omnimedia, Inc. v. Stewart, 845 A.2d 1040, 1050 (Del. 2004). If the courts do recognize these biases, they typically assume that a director's good faith efforts or competing interests, such as a director's reputational interest, will prevent biased decision making.

There is a widespread presumption, in courts, regulator's minds and governance codes, that independent directors can make decisions without being affected by their own preferences, motivations and social ties, or that directors acting in good faith are capable of overcoming their biases (Marnet, 2008). In contrast, bias can be shown to significantly weaken the functional independence of non-executive directors, with invariably negative consequences for accountability and stewardship. Social-psychological factors significantly undermine corporate governance mechanisms ostensibly designed to monitoring and controlling CEO behaviour. The impact of bias on decision-making particularly questions the contribution of the independent director, frequently upheld as a major remedy to agency problems. Widespread board acquiescence to what subsequently is revealed as poor corporate decision making indicates a need to explore key behavioural effects on the quality of decision-making in the boardroom.

Based on a synthesis of more than four decades of social psychology research, the presumption of independence based on simple metrics focusing on the absence of financial and family ties is inadequate. Regardless of a director's good faith, unconscious and, to a significant extent, uncontrollable cognitive processes prevent the director's decisions from being unaffected by their preferences and board loyalties. Biased decision-making can thus occur in the absence of direct or indirect monetary incentives. Psychological research shows that individuals can often neither identify nor control own biases. Biases can be unconscious, and people may unknowingly favour themselves, their friends and their groups, to the detriment of the firm and its shareholders. The broad argument being that parties with an interest in viewing facts in a certain light are not capable of independent and objective judgment (Moore and Lowenstein, 2004; Moore et al., 2003).

Challenges to the dominant governance paradigm have come from those who question the ability of non-executive directors to satisfactorily perform the variety of roles expected from them[2], and from those who argue that the 'approved' governance mechanisms put in place have been demonstrably ineffective in checking corporate irregularity to date and are unlikely to be any more effective in the future (Clarke et al, 2003). An example of related research is given in Marnet (2007) who cautions against the exclusive use of the rational choice model of decision making in explaining agent behaviour in corporate governance and proposes the use of psychologically more realistic assumptions. Prentice (2003) examined Enron's collapse using a behavioural perspective, to arrive at more realistic policy prescriptions than those that can be derived from a strict reliance on the rational actor model interpretation of human behaviour. These authors argue that conventional law and economics theory suffer from major shortcomings by ignoring behavioural insights which forceful demonstrate how law and economics (and much extant governance regulation) is built on a raft of inaccurate assumptions on human judgement and decision making behaviour, leading to faulty policy prescriptions. By applying behavioural decision theory to issues of governance, the foundational assumption of law and economics that people typically and consistently behave

[2] See for example Ezzamel and Watson (1997), see also Spira (2003) and Spira and Bender (2004) for further discussion of this issue.

rationally is shown to be quite misleading, and grossly inadequate in explaining the frequent occurrence of corporate scandals.[3]

Controlling for managerial conflicts of interest is one of the essential monitoring functions of the board (Langevoort, 2001a). Yet, a board is subject to potential problems of dependence, social ties, loyalties, and behavioural norms which form the environment of group decision-making. In the extreme, senior management may capture the board and thus void much of the latter's monitoring functions. The typical selection for membership on boards of directors is heavily based on compatibility, fit, consensus, and cooperation (Langevoort, 2001b). Jensen (1993, p. 863) reflects on board culture as an important component of failure of board function when he describes an atmosphere of: "… *courtesy, politeness and deference at the expense of truth and frankness during board meetings, reflecting a general reluctance of confronting a CEO regarding management decisions, which is seen as both a symptom and cause of failure in the control system."* (Jensen, 1993, p. 863).

An overly strong emphasis on teamwork and conflict-avoidance by boards may be evidence of capture by the CEO. Board capture provides the CEO with significant powers to engage in activities which may be to the detriment of stakeholders (Bebchuk et al., 2002). This interpretation of managerial power would seriously undermine the arm's length model of boards and their crucial watchdog function, and is in stark contrast to the optimal-contracting view where directors take an adversarial position against management (Bebchuk et al., 2002). The very psychology of a board is tilted toward supporting the chief executive. Short of firing the CEO, open dissent is rarely found in board meetings.

Board capture is not the only, nor a necessary, influence bearing against independence. Groups such as boards of directors, are highly subject to groupthink (Janis, 1972) and polarization (McHoskey, 1995), with potentially negative effects on the quality of decisions. The pressures on a board of directors towards consensus opinions, leaves it highly subject to the (negative) consequences of groupthink (Janis, 1972, 1989). While an ideal board would act to counter the groupthink tendencies of an in-group, group social effects are a potent influence against critical opinion. The social dynamics that exist in any group move members towards placating other group members, and to arrive at a consensus view. This acts as a strong counterweight to the potential for group decision making to moderate an extreme position, and instead can lead to further polarization (Janis, 1972; Myers, 1982; McHoskey, 1995). Group processes, such as a board deliberations, have also been found to increase biased pre-decision processing (biased processing before committing a consequential decision), with this biased processing increases as the difficulty of the decision increases, reflecting the typical environment of boardroom decisions (Brownstein, 2003).[4]

[3] See Prentice (2000) for a detailed application of behavioural insights to auditing and accounting. Also, Coffee (2003a,b) who investigates behavioural and regulatory causes of the failures of gatekeepers in corporate governance.

[4] Human inference is subject to a set of cognitive and motivational filters which persistently interfere with an objective interpretation of information, including over-optimism; escalation of commitment; prior views, decisions and experience; emotional attachment; confirmation bias; a preference for the status quo; obedience to authority.

Bias is likely a major cause of the poor judgement that ultimately leads to the destruction of much corporate value. The more obvious and highly publicised cases of destructive (and fraudulent) leadership such as Enron and WorldCom are, thankfully, quite rare, although bias undoubtedly played a major role in the (poor) decisions of the respective boards. A more insidious problem is the potential for massive destruction of shareholder value stemming from common and widespread behaviours of corporate elites and board members where fraud may not play a major role (or indeed none at all) but changes in leadership do not take place before the damage (in terms of shareholder value) is done (Gwilliam and Marnet, 2010; Forbes and Watson, 2008; Marnet, 2008). Examples of non-rational (in the economists' interpretation) behaviour include commitment to lost causes, belief perseverance, and the underestimation of risk. Cognitive dissonance (the clash between conduct and principles), frequently leads to beliefs being adapted to conform with own conduct, which further distorts perception and judgement.[5] Even when individuals realize own bias in a particular judgement (and are explicitly asked to watch out for this), they are frequently unable to sufficiently adjust for this.

Such insights have profound implications on the definition of independence. The standard governance paradigm focuses on business and family relationships, and is essentially based on financial incentives. The inconclusive relationship found in research between corporate performance and the proportion of independent directors on the board or the various committees supports the argument that the benefits of independent directors, as traditionally defined, are limited (Mehran, 1995; Klein, 1998; Bhagat and Black, 1999, 2000, 2002), suggesting a rethink of definitions of independence. Functional independence, in the sense of directors being professional referees (Fama, 1980), board monitors (Fama and Jensen, 1983a,b) and gatekeepers (Coffee, 2001), remains an elusive goal (Clarke et al., 2003), and bias may significantly undermine the value of the independent director. Indeed, some scholars would argue that initiatives such as increasing the number of independent directors on a board and board subcommittees are manifestations of the agency problem rather than a solution to it (Bebchuk and Fried, 2003). Enron, WorldCom, Lehman Brothers, and many other prominent companies that collapsed or suffered massive damage due to poor decisions at board level had a majority of independent directors on the board. It would appear that the perceived benefit of independent directors—unbiased judgment - is achievable in the exception only. This makes the independent director, in its present form, a weaker component of good governance than commonly assumed.

This is not a question about integrity. No doubt, most directors wish to be objective, rational, competent, honest, and see themselves as such. But there is sufficient reason and evidence to doubt their ability to avoid falling prey to the powerful effects of psychological bias. If bias can result not from corruption or intentional malfeasance, but rather from unintentional (and often unconscious) motivational and cognitive processes, unbiased decision making may be beyond the best of directors' abilities. A decision maker will frequently not recognize situations involving potential bias and conflict of interest. Subtle conflicts of interest, like those involving directors' indirect personal and social benefits, may not be obvious to directors who interpret

[5] A further complication is that preferences and beliefs may not be formed prior to observations of own behaviour. Hence the causation may, at times, run from behaviour to beliefs (see Bazerman and Malhotra, 2006).

their situations differently from impartial observers. To compound the problem, even where people allow for the possibility of their judgement and decisions being biased, they typically underestimate the effect, and insufficiently adjust for this.

This has the further implication that if a problem is a lack of conscious awareness, the solution cannot be based on conscious cost-benefit analysis. This would greatly diminish the impact of sanctions as a guide to behaviour.[6] The explicit view, based on people knowing their preferences, yields the traditional, but largely ineffective, regulatory and legal response to corporate scandals such as imposing sanctions on violations of professional standards, more rules, disclosure of conflicts of interest, and other interventions aimed at changing the cost/benefit calculation of the decision maker who might be tempted to act dishonestly. If most of the problem is implicit, with people being out of touch with what guides their own behaviour, these explicit barriers to corruption will have limited impact.

It is particularly difficult to maintain the duty of independence and objectivity where unanimity in boardroom decision making is emphasized or even required. The expression of independent judgement is actively inhibited where this openly conflicts with the views of executive management and the Chair. Accountability under such pressures is then undermined. This will directly impact on responsibilities for the determination of the nature and extent of significant risks to the organization and will affect, among others, the board's judgement of the appropriateness and effectiveness of the organization's risk management and internal control systems.

Biased judgement would also appear to contribute to the phenomenon of destructive leaders. Padilla et al. (2007) argue for destructive leadership to take hold and to generate extreme negative outcomes there typically needs to be a 'toxic triangle' consisting of 'destructive leaders, susceptible followers and conducive environments'. All three of these elements are present in the widely-held corporation (and, typically, other organizations). Executive leaders frequently cultivate susceptible followers and create the necessary conducive environment through their exploitation of a pronounced 'loyalty bias' (Forbes and Watson, 2010). This may lead in even formally 'independent' boards of directors displaying excessive loyalty towards their CEO's long after it has become apparent to outsiders that the incumbent CEO is destroying corporate value and ought to be replaced.

Finally, induction sessions, and recommendations to regularly update and refresh skills and knowledge, as suggested in the Higgs Guidance and discussed in the current ICSA Review of the latter are a necessary ingredient to promoting effectiveness. Experience and best practice would suggest that areas where directors need a minimum amount of knowledge include, in addition to a sound knowledge of the firm, the industry, and the economic environment, should focus on financial analysis, risk management, and governance. However, formal training on such issues will not inevitably lead to better decision-making if the effects of bias are ignored or acknowledged in passing only. Appeals to 'objective', 'rational', 'independent', and 'informed' decisions will largely fail to have the desired effect

[6] Bazerman & Watkins, Predictable surprises: The disaster you should have seen coming and how to prevent them (2004) (arguing that recent financial scandals were caused in significant part by auditors' lack of independence).

where board processes and procedures do not actively aim at the minimization of inevitable bias affecting individual and group judgement.

Conclusion

This comment made the main argument that critical assessment of and dissent to poor executive decisions is undermined by biases on the judgement on the board, and the independent director in particular. Despite best intentions, bias in the boardroom is inevitable, board dominance by executive managers wide-spread, and the independence of non-executive directors more evident in its absence. Constructive debate and challenge remain elusive in boardroom deliberations, with detrimental effects on the quality of decisions.

While bias in perception, judgement and opinion formation is inevitable, boards can improve their decision-making processes to minimize the impact of bias on decision quality. The presence of bias on board decision-making calls for a change in boardroom processes and highlights the need to implement guidelines which aim at de-biasing judgement and decision-making. This is particularly relevant to group-decision making where it is suggested that boards institutionalise (legitimate) dissent and are mandated to implement procedures to counter bias formation.

Serving on a board inherently creates the risk of a biased decision-maker. Changing the decision maker remains a possible solution, which has implications for the rules and guidelines on board membership, the rotation of board members, tighter rules on tenure and the re-election, the need for outsiders to come on a board, and cross-membership. It is imperative to separate the decision-maker from the performance monitor. The same board (or board members/committees) cannot reliably form judgement over the performance of a project or decision for which it was originally responsible.

One particularly powerful way to elicit a truly independent view is the election of strictly time-limited directors, without possibility for renewal or subsequent re-election, with the explicit task to identify weaknesses in the governance of the firm. Such outsiders can act as a potent guard against the inevitable in-group tendencies which diminish the perceived benefits of non-executive directors. Electing two to three such outside directors at a time allows the creation of a critical mass as a counterweight to established views on the board.

It would be of immense additional benefit for a board to have regular meetings without executive management present, and for additional meetings between the board and the external auditor, again without the presence of executive management. A board may also wish to elect a lead independent director tasked to hold regular meetings with other independent directors to discuss important decisions and proposals. Such a lead independent director might also be called upon to act as a co-chair in setting agendas and the general tone on boardroom deliberations.

With regard to board deliberations, boards may wish to consider a number of decision-making strategies that can reduce the impact of unconscious bias. Such

approaches include dividing the task into first an information search, a general discussion and then a decision by different group members or separate committees (the ICSA Review notes: "Some chairs favour, for example, three separate discussions for important decisions – concept; proposal for discussion, proposal for decision"); seeking the advice of true outsiders; requiring decision makers to justify their information choices; appointing a 'devil's advocate', thereby ensuring opposing arguments are given at least somewhat more consideration; deliberately framing a decision problem in multiple ways; the requirement to seek dis-confirmatory information (i.e. to look for information and arguments which do not support a proposal), as people are less likely to simply conduct confirmatory searches for information when they are led to consider the contrary proposition before the search. This positive effect occurs even when the decision makers' mindset has been affected without their conscious awareness.

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