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(Editor)

Governance of Ventures

The Role of Venture Boards, Entrepreneurs
and Investors in Entrepreneurial Value Creation

Haupt

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Free-Energy Governance – An Approach to Effective Venture Governance

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Abstract

Venture governance is essentially about activating generative social (learning) fields around an emergent activity. A venture's purpose is dissected into top-down hypotheses that are to be tested, confirmed or refuted by bottom-up and action-generated data-points. Venture governance is action-centric hypothesis-testing. Neuroscience's free-energy principle (or prediction error-minimization) provides the theoretical framework for a governance regime centered around the bottom-up (field) challenge of top-down (upper echelon) predictions. The simplicity and clarity of the venture's purpose, the 'free-energy' design of structure and (learning) processes, and cognition in form of organizational sensing and sense-making capabilities constitute venture governance's three meta success components.

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"We live in a moment of profound possibility and disruption. A moment that is marked by the dying of an old mindset and logic of organizing. And one that is marked by the rise of a new awareness and way of activating generative social fields."

C. Otto Scharmer, 2018

A venture's subject matter – whether at a project, joint or corporate level – is by definition 'in emergence', i.e. "a new activity, usually in business, that involves risk or uncertainty", according to Cambridge Dictionary. Therefore, venture governance is fundamentally about the structure, processes, and capabilities that empower the success of emergence.

While venture governance may apply certain 'best practices' elements of public corporate governance such as independent directors, domain-specific board committees, and codes of conduct, it is the scope, size, and complexity of the venture's contents as well as the nature and path-dependency of its very stakeholders that will eventually determine the details around the process and structure of the governance arrangement to be adopted. Stakeholders' goal-directed alignment of interest to succeed distinguishes venture governance from public corporate governance, which is overly concerned with managing conflicts of interest. There is no 'one-fit-all' regime. But a meta-governance model can be distilled to 'super-guide' the successful governance of new and innovation-centric business activities, in particular in dynamic and uncertain environments, irrespective of firm or project size, lifecycle, or industry.

For the purposes of this publication, a venture is defined as a socially-constructed and goal-directed activity in search of an optimal governance (learning) arrangement to mitigate the inherent risks and market-related uncertainties of building something new. Because of the activity's emergent nature, the governance arrangement must facilitate fast learning. In fact, a venture's goal is dissected into top-down hypotheses that are to be tested, confirmed or refuted by bottom-up and action-generated data-points. Venture governance is essentially about action-centric hypothesis-testing.

Continuous, goal-directed and generative 'fail-fast' experimentation and hypothesis-testing in product, client or other resource markets are critical to the venture's overall success. It is a social process linking in circular causality top-down (Upper Echelon) predictions with bottom-up (field and business unit) action-generated data points. Hence, the governance challenge is to facilitate a rather inclusive, hierarchy-transparent, goal-directed, and generative sensing and sense-making process. This is strategy as hypothesis (Dong et al.; 2016). In sum, venture governance must be designed to foster generative hypothesis-

testing that engages all hierarchical layers. The relevant capabilities are no longer limited to domain expertise but are increasingly of a cognitive nature, in particular generative sensing and sense-making to optimally approximate fulfilment of the venture's purpose.

"The challenge of sensing capabilities is that their effectiveness relies on the cognitive lens that is used to observe and interpret the world around us. The fundamental tradeoff is between the uncertainty minimization of deductive and inductive logic that leads to crisp answers about opportunities but can miss the opportunities that are too anomalous or too ambiguous." (Dong et al., 2016) It is that cognitive meta-lens serving as a foundation for a venture's sensing and sense-making capabilities that is shaped by three critical dimensions: (a) an enactivist worldview: environment is not exogenously predetermined but is enacted through the social construction of shared meaning and action; (b) the clarity of the venture's purpose and target model; and (c) a dissonance-centric quest for filtering anomalies relative to the target-model's predictions without missing opportunities embedded in the very anomalies.

Neuroscience's free-energy principle (also referred to as prediction error-minimization process) provides the theoretical framework for venture governance. Free-energy is defined as the mathematical difference between prediction and its accuracy. In short, free-energy should be minimized. A high degree of free-energy suggests that our predictions are wrong and that not just the predictions but the very models that generate those predictions in the first place may have to be ultimately changed.

At its core, 'Free-Energy Governance' is the understanding of governance as a process empowering "transitions from states of ignorance to states of insight" (Friston et al., 2017). The effectiveness of 'Free-Energy Governance', similar to the brain's prediction-error-minimization process, is determined by organizational structures characterized by high 'recognition densities'. (Friston et al., 2017) 'Recognition density' is a measure for 'message passing' and 'belief propagation' (Friston et al., 2017) – in-between hierarchical layers, i.e. top-down and bottom-up, as well as laterally within every one layer of the hierarchy. 'Message passing' and 'belief propagation' are the expression of generative, goal-directed, and action-based organizational sensing and sense-making.

The shortcoming of most governance models is the fact that they are too top-down centric – trapped in the obsession with optimizing structure, processes, and competencies within the boardroom or 'leadership cockpit' – without embracing the organization and its ecosystem more holistically. Once we adopt a 'Free-Energy-Principle' perspective, we start seeing how essential it is that a governance regime is empowered to facilitate a bottom-up (field) chal-

lenge to top-down (Upper Echelon) predictions and its prediction models – in circular causality. The effectiveness of lateral sensing and sense-making – i.e., within each hierarchical layer – is essential for top-down/bottom-up free-energy minimization to come alive. Otherwise, 'message passing' and 'belief propagation' are sub-optimal at best, failing to leverage the venture organization's full potential, within and beyond its formal boundaries.

What does this mean for practice? There are essentially three dimensions shaping the success of venture governance: purpose, structure and process, and cognition.

1. The simplicity and clarity of the venture's purpose lays the foundation for success. Purpose must be framed and communicated in plain, non-technical, and accessible language. Lack thereof will fail taking advantage of the organization's full potential. "Each individual brain is embedded in a world of other brains" (Eagleman, 2017), and "we can plausibly look at the accomplishments of our species as the deeds of a single, shifting mega-organism." This is equally true for the organization as a microcosm and, in particular, for a venture typically characterized by the dynamics of emergence. Every brain is an essential nod in the free-energy-minimization process and must be continuously and socially engaged for purpose-directed sensing and sense-making. Clarity and simplicity of the venture's purpose are essential to engage the entire organization and its ecosystem to collectively generate relevant bottom-up stimuli to challenge top-down predictions.

2. Structure and process must be designed to facilitate 'free-energy minimization'. Venture governance and, for that matter, any governance regime is fundamentally about free-energy minimization, empowering the data of the field to talk to decision-makers: to bottom-up challenge top-down predictions and its underlying 'world models'. In particular, in venture governance – however, no less relevant they are in public corporate governance – informal processes and channels of communications become more important than the surface of formality. In my personal experience, I found thematic (hypothesis-specific) and hierarchy-transparent ad-hoc 'deep-dives' very effective for creating a 'free-energy-minimization' centric governance regime. The set-up is such that a core group of domain-relevant board members and selected representatives of middle- and field-management join in 3-4 hours sessions dedicated to a shared purpose, i.e. create new or challenge existing predictions and prediction models in specific areas deemed to be critical to the venture's overall success. "The deep-dive journey" aims at moving "one's operating perspective from inside a familiar world – the institutional bubble – to an unfamiliar world outside that is surprising, fresh, disturbing,

exciting, and new." (Scharmer, 2018) Unless field management is convinced that their role is not just about execution but one of 'listening' to effectively dialogue 'dissonant' field intelligence to the top, a venture organization – in fact, any organization – is likely to compromise its full-potential 'free-energy minimization'.

3. Cognition is a critical component of venture governance's success algorithm. In a distributed and highly dynamic market environment, the importance of cognitive skills relative to domain expertise is on the rise. 'Listening' in terms of sensing and sense-making are cognitive skills that are not necessarily given but must be learnt and cultivated on an individual as well as organizational level. Sense-making starts with an observation, i.e. sensing that 'something does not fit'. "As anomalies become shared, sensibleness should become stronger." (Weick, 1995) Unless meaning is cross-hierarchically shared and tested, top-down and bottom-up, there is no organizational sensing and sense-making. It is a form of 'co-sensing' enabling "seeing reality from the edges of the system" by shifting "the power dynamics from individual to shared ownership, and from ownership to belonging, to seeing your part in a larger social field." (Scharmer, 2018) Action is at the center of sensing and sense-making. "Instead of seeing perception as the control of action, it becomes fruitful to think of action as the control of perception." (Clark, 2016) Therefore, the success of venture governance is a function of empowering the field-level to act in form of forward-oriented experimentation, 'listen' to the action-generated data, and be prepared to fail-fast to leverage failure for future success, in circular causality. This is 'free-energy minimization'. Board and executive leadership are no less challenged to learn 'listening' and avoid the trap of a pre-set 'venture-paradigm' mixed with the distortions of domain-bounded and past-tense-fuelled pattern-recognitions. "Open up all four 'channels' of listening: Listen from what you know, from what surprises you, from the whole, and from what you sense wants to emerge (the emerging whole)." (Scharmer, 2018)

'Free-Energy Governance' is the opening chapter for a new logic of organizing. In particular, the effectiveness of venture governance (or the governance of emergence) is fundamentally a matter of 'free-energy minimization'.

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In times of disruption, venturing becomes a key source of value creation. As new opportunities emerge and existing models fade, entrepreneurs, corporates and investors are eager to explore and exploit those opportunities. Venture governance, i.e. defining, implementing and following a fit-for-purpose model to provide direction and control in the best interest of all stakeholders, plays a crucial role in enabling and ensuring entrepreneurial value creation.

This book presents twelve perspectives on the governance of ventures, bringing together viewpoints from both practitioners and academics. It provides practical insights, introduces new perspectives and invites the reader – whether a member of a venture board, an entrepreneur or an investor – to reflect on their own approaches to venture governance.

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