On the functions of supervisory boards in the Netherlands

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Abstract

In corporate governance systems boards perform three functions: the interlocking function (from a resource-dependency and network perspective), a monitoring function (from an agency perspective), and a strategic function (from a strategic choice perspective). In a one-tier board the board of directors incorporates non-executive directors (outsiders, they sometimes represent the interests of key-stakeholders) and executive directors (top management) of the firm. In a two-tier board there is a clear distinction between the directors as members of a supervisory board and the top management team. The board serves in this respect as a supervisory board vis à vis the management board. In the Netherlands a two-tier board is prevalent. Firms who act under the structural regime have boards that are characterized by the co-option principle. This means that board members have to act in the best interest of the firm and ultimately choose each other (and are not chosen by the shareholders or other stakeholders). Co-option has some advantages, but also some clear drawbacks, such as the potentiality of groupthink. The structural regime and other governance regimes, in which the relationship between supervisory board and management board is established, have moderating effects on the hypothesized relationships between the three functions and performance of firms.
1. Introduction

Different corporate governance systems can be distinguished by the institutions that organize the interests of stakeholders. In the literature, the issue of corporate governance is usually associated with the 'principal-agent' problem (Berle and Means, 1932), which only addresses the conflict of interests between managers and a subset of stakeholders, the shareholders (owners/investors). In this respect, the monitoring function of boards has received most attention. For instance, comparative research into the effectiveness of one- and two-tier board systems has largely taken a corporate control perspective (e.g. Gelauff and Den Broeder, 1996, and Johnson and Scholes, 1997). Furthermore, most empirical research has focussed on one-tier boards in Anglo-Saxon firms (c.f. Boone et al., 1995).

In this paper, we therefore choose a somewhat different approach. In the first place, by analyzing the role of the supervisory board in the Netherlands, we particularly focus on the characteristics of the two-tier board system. In the second place, we extend the analysis by arguing that apart from the monitoring function, supervisory boards also perform an interlocking function (taking a resource dependence perspective) and a strategic function (taking a strategic choice perspective)\(^1\).

More specifically, our first objective is to discuss the theoretical contributions and functions relevant for the supervisory board (section 2). Our second objective is, by using these functions, to describe the characteristics of the two-tier board system in the Netherlands (sections 3 and 4). Our final objective is to discuss in what way corporate governance systems influence the relationships between the functions and performance of firms (section 5). Finally, section 6 concludes with some policy implications and suggestions for subsequent research.

2. Theoretical foundations of (supervisory) boards

2.1 Theory of boards: Fama and Jensen

Probably the most explicit theoretical underpinning of the monitoring function of (supervisory) boards is Fama and Jensen (1983), but also e.g. Williamson (1996) considers the board as an endogenously derived control instrument on behalf of the residual claimants. Both regard an organization as a nexus of explicit and implicit contracts. Information problems prohibit the specification of contracts over all possible contingencies. As a result, contracts are necessarily incomplete, leaving the allocation of residual rights to alternative institutions that define the governance structures of firms. Some of these institutions specify the allocation of decision rights

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\(^1\) In this paper, the Dutch board will be mainly discussed from the perspective of the international corporate governance literature. This literature is generally more shareholder than stakeholder oriented.
over corporate decision makers. In explaining this allocation Fama and Jensen divide the decision-making process into four steps:

- **Initiation**: generation of proposals for resource utilization and structuring of contracts.
- **Ratification**: choice of the decision initiatives to be implemented.
- **Implementation**: execution of ratified decisions.
- **Monitoring**: measurement of performance of decision agents and implementation of rewards.

Decision management denotes the initiation and implementation rights, decision control the ratification and monitoring rights. Fama and Jensen argue that under incomplete information, agency problems arise in case corporate decision makers do not bear the full wealth effect of their decisions. In that situation, granting both management and control rights to one and the same decision maker will result into suboptimal behavior. Hence, decision management is usually allocated to the regular management and decision control is reserved for monitoring agents. Only in small noncomplex entrepreneurial organizations, were top managers are the owners (or closely connected to owners), it is efficient to allocate both decision control and management to these top managers. On the other hand, in large complex firms with dispersed ownership it is costly to exercise and organize corporate control. In that situation it is more efficient to delegate decision control to a board. Such boards have the power to hire, fire, and compensate the top-level managers and to ratify and monitor important decisions. Residual claimants (shareholders) generally retain approval rights (by vote) on such matters as board membership, auditor choice, mergers, and new stock issues. In one-tier board systems, corporate boards generally include (internal) top level managers and outside members. Top managers are needed to provide the internal information on decision alternatives and performance of the various managers (also top managers) in the organization. This information is used to set the rewards of the top managers, to rank them, and to choose among their decision initiatives. The chief executive officer often acts as a chairman of the board. The outsiders act as arbiters in disagreements among internal managers and carry out tasks that involve serious agency problems between internal managers and residual claimants. Most outside directors are top managers of other corporations and therefore credible decision experts. In two-tier board systems, the separation of management and control is most clearly formalized by the institution of an independent supervisory board and the rule that prohibits insiders to be members of supervisory boards (see also section 2.3).

### 2.2 Functions of supervisory boards

In general, there are three views related to the functional duties or roles of the board (c.f. Goodstein et al., 1994; Dalton et al., 1999). The first emphasizes the institutional
function in which the board helps to link the organization to its external environment and secure critical resources. The second refers to the monitoring or governance function. This perspective stresses that the board of directors can be considered as an internal governance and monitoring mechanism for alignment of shareholders and management. The third function is the board’s contribution to the strategic decision making processes in organizations.

The interlocking function of the supervisory board refers to the institutional function of board structure, indicating that by increasing size and diversity of boards, links to the external environment can be established and critical resources be secured, including prestige and legitimacy (Goodstein et al., 1994). Also from a transaction cost economics point of view the board is reserved for those stakeholders who supply or finance firm specific assets (Williamson, 1996). This ‘resource dependency’ perspective emphasizes that the environment may constrain corporate activities and indicates power/dependence- or inter-organizational relationships. It sensitizes managers to likely sources of influence from the environment and suggests ways to anticipate them. In this respect, Pfeffer and Salancik (1978) state: “The typical solution to problems of interdependence and uncertainty involves increasing coordination, which means increasing the mutual control over each other’s activities” (p.43). To this aim, many strategies can be used. The board is only one way to relate an organization to its critical resources in the environment and vice versa. For instance, developing personal relationships with board members of firms on which yours depend, by interlocking directorships might be an option. Interlocking functions can be developed in two ways: outsiders (often top managers) can be recruited from financial institutions or other firms. On the other hand, insiders (managers) can also participate in boards of other firms. Therefore, also members of the management board perform this interlocking function. The 'network perspective' of this function is based on the idea that members of the supervisory board undertake interlocking activities on behalf of the firm in order to develop and maintain long-term relationships (OECD, 1998). Trust and interdependence are central elements of relational contracting (Huse, 1994). Social contracts in this respect are characterized by relational norms. These norms, based on trust and interdependence, are in fact the governance mechanisms that govern the relationships between parties.

The monitoring function rests in agency theory (Fama and Jensen, 1983). Monitoring in this respect means monitoring and governing the management on behalf of the shareholders. We already indicated in section 2.1 that in large complex firms it is more efficient to have a board as a representative institution for the

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2 This ‘resource dependency’ function rests in the early research findings on ‘resource dependency’ by Pfeffer (1972, 1973), indicating that board size and board composition is related to resource dependencies and regulatory pressures. It is more fully developed by Pfeffer and Salancik (1978).
dispersed shareholders. The board approves decisions, appoints and or removes ineffective individual managers or management teams (c.f. Barnhart et al., 1994). The implicit assumption of agency theory in this respect is that corporate boards of directors perform their governing function effectively (Sundaramurthy, 1996). In this respect, there is a trade-off between organization of control rights, for instance in the context of one and two-tier board systems and alternative institutions that discipline management and prevent opportunism: the market for takeovers, the product market, the labor market for (top)managers, etc. The board's role as monitor will also depend on the complexity of the decisions facing managers and directors (Lorsch, 1995).

A **strategic decision making (formation) and ratification (evaluation) function** in which the board participates actively in strategic decision making (decision control) and also has a responsibility of decision maker of last resort (decision management). In situations in which management don’t bear a major share of the wealth effects of their decisions, the board is the common apex (Fama and Jensen, 1983). Judge and Zeithaml (1992) discuss the strategic choice perspective, which focuses on non-deterministic explanations of organizational process and outcomes (p.770). They emphasize the idiosyncratic discretion of managers and board members to adapt to the environment. This function of the board indicates that next to management, members of the board of directors also are actors in strategic decision making processes. “The strategic role of the board involves taking important decisions on strategic change that help the organization adapt to important environmental changes” (Goodstein et al., 1994: 242), examples are mergers or large layoffs of workers. This decision making part sometimes follows from the institutional (legal) context. Board members in their quality as director also initiate strategic decisions. The ratification (evaluation) part of this strategic function follows from Fama and Jensen’s distinction between decision management and decision control. Ratification refers to the authorization aspect of decision control.

Finally, in this discussion of the governance functions of boards three relevant agents show up: stakeholders and especially shareholders; (supervisory) board members; and managers. The relationships between these agents can be discussed in terms of the aforementioned functions. The ‘interlocking function’ refers to the formal and informal networking relationships between stakeholders and managers. The monitoring function and the strategic decision making function are more specifically aimed at the relationship between board members and managers.

### 2.3 Board systems

As already mentioned, there are two alternative board systems: a one-tier board and two-tier board, see figure 1.
Figure 1: One-tier and two-tier board

One-tier structure

Shareholders

Insiders (top executives)

CEO

Outsiders

Two-tier structure

Shareholders

Supervisory board

Management board
In a one-tier board system both internal directors (managers) and outside directors can be members of the board, all having equal responsibilities. The board essentially supervises managers, sometimes also in the form of a subcommittee, which allows for a more detailed involvement of the board with the work of the managers. There is considerable variance in the design and functioning of board committees (Vance, 1983). In a two-tier board system there is a supervisory board consisting of primarily outsiders. In this situation the board of directors is placed next to or above the management board. The differences between a one-tier and a two-tier board boil down to the composition of the board and the dual position of the chairman. Board composition involves the mix of inside directors (those employed by the organization) and outside directors. The supervisory board in a two-tier board contains practically no insiders and has an independent chairman. The board in a one-tier situation consists of various insiders, including the CEO as the chairman of the board. Recently, greater outsider representation is often advocated since outside directors are likely to be more objective in monitoring management actions than inside directors (Sundaramurthy et al., 1997). In Anglo-Saxon countries, such as the US, UK, Canada, Australia, the one-tier board is prevalent. In German and Dutch corporate governance systems, the two-tier board applies (c.f. Moerland, 1995). Because of the fact that the main task of a supervisory board in a firm is to supervise the top management team, it can be defended that a supervisory board is hierarchically and legally placed above the top management team. Supervision in principle encompasses at the same time controlling of and co-operation with the management board.

2.4 Dimensions of board research: operationalization of functions
The three functions of the board (see section 2.2) are often explicitly related to questions of its size and composition (Vance, 1983). Empirical studies in this field have focused on various board composition attributes such as: board size (the number of members on the board), insider/outsider ratio, board members’ stock ownership (the stake of board members in the firm in terms of shares or options; no shares or options means more independency), CEO-duality (the combination/separation of the position of CEO and board chairperson) (c.f. Rosenstein and Wyatt, 1990; Rechner and Dalton, 1991; Barnhart et al., 1994; Huse, 1994; Sundaramurthy, 1996; Daily and Dalton, 1997; Dalton et al., 1998).

As discussed in the previous sections, the interlocking function of directors refers to their ability to extract critical resources from the organization’s environment. The resource dependency theory has been the most important (theoretical) foundation for the observation that larger boards are associated with higher levels of firm performance (Dalton et al., 1999). This view stresses the idea that board size is a measure of an organization’s ability to form environmental links to secure critical resources, although Judge and Zeithaml (1992) indicate that the size of the board is
negatively related to the board’s involvement. Yermack (1996) even finds a negative association between board size and firm value. So, we must be careful in using this measure. Also, the ratio of insiders to outsiders is relevant in this context: a higher level of insider representation is negatively related to overall board involvement ("inside directors are eunuchs" one CEO commented: Judge and Zeithaml, 1992: 785). In Germany the so-called ‘mitbestimmung’ or participation of worker representatives in the board is an important institutional feature of the board (Gelauff and Den Broeder, 1996). In continental European countries, (informal) financial networks can be distinguished between the boards of various firms (c.f. Chirinko et al., 2000). Board members sometimes are even clear representatives of institutional investors, or firms that provide venture capital. This means that the background of directors (representatives of various stakeholders: workers; shareholders, venture-capitalists, etc.) can be relevant in this respect. Finally, the reputation is at stake. Fama and Jensen (1983) stress the reputational effects of supervisory board members, because they are publicly visible as either managers of other firms or important decision makers in other organizations (for instance governmental organizations). In short, the size, the composition, the background of directors, reputation, and the way they are chosen are indicators of the interlocking and network aspects of this function.

Directors who perform a monitoring function should be independent. This actually means that they should be outsiders. In analyzing the monitoring function of the board the proportion of outside directors in the board is related to the performance of the firm (c.f. Rosenstein and Wyatt, 1990; Lee et al., 1992; Barnhart et al., 1994). Results are mixed, varying from a weak to a strong relation between outside directors in the board and performance. For instance, Rosenstein and Wyatt (1990) find that the addition of outside directors increases firm value. Rosenstein and Wyatt (1997) also conclude that there is no effect on appointment of new inside directors. Bhagat and Black (1997, 1998) conclude that there is no convincing evidence that board composition affects (future) corporate performance. For past performance some evidence is found. However, Klein (1998) shows that independent directors can add value if they are embedded in an appropriate committee structure. A recent meta-analysis of Dalton et al. (1998) of 54 empirical studies showed, for the US-situation, that board composition (especially insiders vs. outsiders) virtually has no effect on firm performance. The degree of independence of board members is also determined by board members’ stake in the firm, be it by way of direct stock-ownership or via option schemes as value-related compensation systems. The higher the stake, the more directors have a direct interest in the firm and the less distance they have from management decisions as such. To put it differently, their position in the firm is not as ‘objective as an independent’ outsider, but more that of a shareholder; which may hamper the monitoring function. Board committees may show up in various forms:

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3 This seems to be confirmed by recent research of the authors at 94 listed Dutch firms.
audit committee, compensation committee, executive committee, finance committee, nominating committee, and public policy committee (Vance, 1983). The prevalence and authority designated to these committees are dependent on legislation and firm conditions. Baliga et al. (1996) indicate that firm (top) managers are able to influence board composition and tenure and set board agenda and control information flows.

CEO-duality refers to a board leadership structure in which the CEO wears two hats, one as CEO of the firm, the other as chairperson of the board of directors (Rechner and Dalton, 1991). Advocates of duality argue that duality leads to superior firm performance as it permits clear-cut leadership focus for objectives, strategies, and operations. Non-duality in this view leads CEO’s to: dilute their power to provide effective leadership of the firm by increasing the probability that actions and expectations of management and the board are at odds with each other; create the potential for rivalry between the chairperson and the CEO; create confusion as a result of the existence of two public spokesmen (CEO and chairman); limit innovation and intrapreneurship if the CEO feels that the board is reserved about his or her actions (Baliga et. al, 1996). Opponents of duality indicate that duality constrains board independence and reduces the possibility that the board can properly execute its oversight and governance role and signals the absence of separation of decision management and control (Baliga et. al., 1996). This results in the idea that CEO-duality systematically reduces the board’s ability to fulfill its governance functions and may constitute a clear conflict of interest (Rechner and Dalton, 1991). The evidence firms opting for independent leadership (no CEO-duality) outperform firms with CEO-duality is not generally found (Rechner and Dalton, 1991; Baliga et al., 1996). Daily and Dalton (1994) indicate that the incidence of a dual CEO-structure in bankrupt firms (matched against survivor firms) was significantly higher. Moreover, their research indicates that bankrupt firms are more likely to have CEOs serving simultaneously as board chairpersons. It can be concluded that despite the mixed empirical results, the boards’ compensation, the board committees, the board composition, and CEO-duality can be regarded as indicators of the monitoring function of boards.

Several studies have found that the board’s strategic function is significant for both the formation of new strategies and the evaluation of former strategic decisions (Judge and Zeithaml, 1992; Fried et al., 1998). Especially boards of directors (with large private equity stakes in the firm) in venture capital backed companies are more involved in both aspects of the strategic function than are boards where members do not have large ownership stakes (Fried et al., 1998). The board of the venture capital-backed firm can be characterized as small and low insider membership (Jensen, 1993), and low diversification (Fried and Hisrich, 1995). Venture capitalists as board members often are directly selected by investors to represent the investor’s interests, which are closely aligned with the stockholders’ interests. This is in contrast to board members in public companies who are either
insiders (managers) or outsiders chosen by the CEO (Fried et al., 1998). Finally, board’s strategic involvement was positively related to the financial performance of an organization (Judge and Zeithaml, 1992). This means that both initiation and evaluation of strategic decisions are indicators for involvement in the strategic function.

To conclude, we will summarize the discussion of sections 2.2 - 2.4 into a set of theories per function of the board. Subsequently, these sets are operationalized by relevant aspects and indicators per theory (see table 1). In the next few sections, we will use the table to describe the Dutch system of corporate governance.

Table 1: Operationalization of board functions

<table>
<thead>
<tr>
<th>Board Functions: theoretical perspectives</th>
<th>Relevant aspects</th>
<th>Indicators</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interlocking function:</td>
<td></td>
<td></td>
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<tr>
<td>- Resource dependency</td>
<td>Interlocking</td>
<td>Size of board</td>
</tr>
<tr>
<td>- Social networking</td>
<td>Trust</td>
<td>Insiders/outsiders</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Background directors</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Reputation</td>
</tr>
<tr>
<td>Monitoring function:</td>
<td></td>
<td></td>
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<tr>
<td>- Agency theory</td>
<td>Monitoring</td>
<td>Board compensation</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Board committees</td>
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<tr>
<td></td>
<td></td>
<td>Insiders/outsiders</td>
</tr>
<tr>
<td></td>
<td></td>
<td>CEO-duality</td>
</tr>
<tr>
<td>Strategic Function:</td>
<td></td>
<td></td>
</tr>
<tr>
<td>- Strategic choice</td>
<td>Strategic discretion</td>
<td>Initiation of strategic dec.</td>
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<tr>
<td></td>
<td></td>
<td>Evaluation/ratification</td>
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</table>

Now that we have established the functions and indicators, the research model can be presented (see figure 2).
In general, we expect positive relationships between board functions and corporate performance. Moreover, we expect a moderating effect of specific corporate governance systems on these relationships. Obviously, contingencies such as the life cycle of a firm, its size, the kind of industry, the kind of ownership structure, profit/non profit character may also have a moderating effect on relationships between the board functions and corporate performance. In the following sections we will abstract from these contingencies.

3. Dutch supervisory boards
3.1 Dutch Institutional context
Within Dutch firms, a two-tier board system prevails: the top management team (the ‘Raad van Bestuur’) and the supervisory board (‘Raad van Commissarissen’). There is a formal separation between the management board and the supervisory board. The management board controls day-to-day operations. The chairman of the management board is the most prominent director and Chief Executive Officer (CEO). He is regularly not involved with the supervisory board (no CEO-duality). The supervisory board generally consists of outsiders (in the sense of non-managers).
Since 1971, the Dutch board system is characterized by three alternative governance regimes: the structural regime, the ‘mitigated’ structural regime and the common regime (Gelauff and Den Broeder, 1996).

1. **The structural regime:** the presence of a supervisory board is obligatory for limited liability firms with a subscribed capital of 25 million guilders, at least 100 employees in the Netherlands, and the presence of a workers council (firms that are a subsidiary of a structural holding are exempted). Gelauff and Den Broeder (1996) estimate 37 per cent of all Dutch public and private firms to be in this class. Of the listed companies two third belongs to the structural regime. The members of the supervisory board are appointed by co-option, members of the incumbent supervisory board elect new members. Top management (and especially the CEO) in practice substantially influences the composition of the supervisory board (Van der Goot and Van het Kaar, 1997). In this regime the supervisory board has potentially substantial power. Firms who are not obliged to adopt the structural regime (see category 3) may, however, choose to voluntarily adopt this regime.

2. **The mitigated structural regime:** this regime applies to those firms that meet the three criteria set out above, but are majority owned (controlled) by foreign companies. In this regime the supervisory board is also obligatory, although in reduced form. The general meeting of shareholders approves the annual statement of accounts and composes the management board.

3. **The common regime:** this regime applies to the remaining limited liability companies. These companies may voluntarily install a supervisory board. Generally, this board has less power and the shareholder meeting takes up the control of the annual statement of accounts and the composition of the management board and supervisory board.

For firms acting under the structural regime, the so-called principle of co-option applies (Gelauff and Den Broeder, 1996). Co-option means that new members of the supervisory board are appointed by the existing board members. The board legally must contain at least three board members. Although the General Meeting of the shareholders and the workers council are legally entitled to nominate candidates and to formally object to the appointment of board members, the principle of co-option

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4 There is also a fourth regime: the exempted regime: firms are exempted from the structural or mitigated regime when they are dependent on a firm that is already subject to one of these regime, when they are part of foreign company, or a mere service organization for affiliated corporations. This regime is not discussed.

5 This potentiality, increasingly, has been effectuated in real power application in situations in which top management makes blunt mistakes or abuses their information position. Also by law this use of the monitoring function is required.

6 For firms not acting under the conditions of the structural regime, the supervisory board is appointed, suspended or dismissed by the annual General Meeting of the shareholders.
effectively limits the direct influence of stakeholders. This means that the quality of (internal) control in the Dutch structural regime will to a large extent depend on the quality and reputation of the supervisory board members. Individual members of the supervisory board have an increasing incentive to act to the best of their knowledge, because of their, recently in the Dutch legal system stressed, personal accountability of their performance. Board members are legally not entitled to be a paid officer (manager) of the firm itself or to be a member of a trade-union (as representative of the workers of that firm).

Van Manen (1999) states that supervisory board members are obliged, as defined by Dutch law, to act in the ‘best interest’ of the corporation (p.6). The problem is that “the best interest is not necessarily synonymous to the best interest of the shareholders” as other stakeholders may also have specific interests. This implies that in the Dutch context, shareholders’ interests are just part of the overall interest of the firm (c.f. Moerland, 1999: 12). Because of the ill-defined character of the term “best interest”, Van Manen and Hooghiemstra (1999) indicate that this too abstract criterion may lead to diverging interpretations of the interests at hand.

An individual member of the supervisory board normally leaves the board for two reasons: his/her (extended) membership period is over or he/she reaches the age of 70. In a supervisory board that operates under the condition of a structural regime an individual board member can be dismissed only by court (‘Ondernemingskamer’ of the ‘Gerechtshof’ in Amsterdam), because of neglect of his/her tasks or changed circumstances. An individual board member can be suspended only by the whole supervisory board. The supervisory board has the authority to appoint, suspend or dismiss members of the management board. The board also has the authority to decide on the annual statement of accounts and to submit it for approval to the annual General Meeting of the shareholders and to simultaneously submit it for discussion in the workers council. For all regimes of the board, the annual General Meeting of the shareholders has the authority to determine the remuneration of both supervisory board and board of directors (unless this has been changed in the statutes). The above discussion can be summarized in table 2

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7 The way supervisory boards have to act in the best interest of the firm is partly founded in the law and can be codified in a code of best practice. In these codes standards for governance are worked out.
8 In firms not acting under the structural regime, the authority to suspend the board of management is in the hands of the supervisory board. The annual General Meeting of the shareholders has the authority to appoint or dismiss the management board members.
9 Although this rarely happens (which is probably not a big surprise given the influence of management on the composition of the board).
Table 2: Characteristics and their scores from Dutch institutional context 1

<table>
<thead>
<tr>
<th>Characteristics</th>
<th>Scores</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governance regimes</td>
<td>Structural, mitigated, common</td>
</tr>
<tr>
<td>CEO-duality:</td>
<td>No</td>
</tr>
<tr>
<td>Choice of directors:</td>
<td>Co-option (37% of all firms; about 66% of all listed firms)</td>
</tr>
<tr>
<td>Reputational effects:</td>
<td>Important</td>
</tr>
<tr>
<td>Background:</td>
<td>No member of trade-union</td>
</tr>
<tr>
<td></td>
<td>No direct paid officer of the firm</td>
</tr>
<tr>
<td>Number of insiders on</td>
<td>None</td>
</tr>
<tr>
<td>the board</td>
<td>At least 3 members</td>
</tr>
<tr>
<td>Size of the board</td>
<td>At least 3 members</td>
</tr>
</tbody>
</table>

3.2 Functions of the supervisory board

According to Van Manen (1999: based on Dutch law texts), in firms under the structural regime, the management board has to submit for approval (ratify) to the supervisory board the following decisions: issue of new stocks or bonds; co-operation to issue certificates of shares; to apply for listing of shares at an exchange or withdrawal; proposal to reduce capital; the initiative to start or stop lasting alliances; substantial participation (> 25% of share capital); investments with a substantial interest; proposals to change the firm’s statutes or disincorporation of the firm; notification of bankruptcy or suspension of payments; and dismissal or changing the working conditions of large number of employees. In this respect, the supervisory board is a strategic decision maker, next to the management board. In general, the task of supervisory board members is to maintain and/or enhance the quality of decision making of the management board. The supervisory board has the duty to oversee that the management board carefully performs its activities. The monitoring tasks of the supervisory board are in general (see Van Manen, 1999): approval of policy proposals; approval of the accountability of the top management team through the annual statement of accounts; dismissal and suspending of top managers; determination of the remuneration of top managers. As far as the two latter tasks are considered to be of strategic importance, board members also initiate certain strategic decisions.

Supervisory boards have the possibility to focus their activities by means of instituting different supporting committees. Directly related to their main tasks, the following committees often are installed²⁰:

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²⁰ See also the Peters Committee (1997, p15 and 29).
The audit committee: supports the communication with the internal and external accountants.

The remuneration committee: aims at proposals for payment for directors/managers.

The nomination committee: nominates candidates for the management board.

Recently, in the Netherlands the debate on corporate governance has been short circuited by the Dutch Corporate Governance committee (also known as the Peters Committee). This committee focused its recommendations for a large part on the relationships between shareholders, management board, and supervisory board in order to arrive at more transparency and accountability of Dutch listed firms. The committee published in 1997 its final report with 40 recommendations (Committee Peters, 1997). For our purpose, only the most important recommendations relating to the supervisory board are considered. The first recommendation concerns the reinforcement of supervisory board independence. By independence is meant being independent of each other, the board of management, and the shareholders. This indicates that especially the monitoring function of the supervisory board should be enhanced. The interlocking function should be restrained. The corresponding recommendation is that members of the board should function without mandate. Also, the recommendation that the number of interlocking board memberships for each director at boards of other firms should be restricted must be considered in this perspective. The strategic function is emphasized by the recommendation that at least once a year the firm’s strategy must be discussed in the supervisory board.

In 1998 the Monitoring Committee (1998) verified if these recommendations were really implemented by Dutch listed firms (sample of 159 firms). The committee concluded that generally the recommendations are agreed upon, but that their practical implementation can not be clearly perceived. Recommendations regarding board independence and annual strategy-discussion are implemented by more than 120 firms. The recommendations with respect to the functioning without mandate and restrained number of directorships per board member are implemented by 80-120 firms. The discussion of this section is summarized in table 3.
Table 3: Characteristics and their scores from Dutch institutional context 2

<table>
<thead>
<tr>
<th>Characteristics</th>
<th>Scores</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initiation of strategic decisions:</td>
<td>Dismissal and suspending of top managers; determination of the remuneration of top managers</td>
</tr>
<tr>
<td>Evaluation/ratification of strategic decisions:</td>
<td>Issue of new stocks or bonds; co-operation to issue certificates of shares; to apply for listing of shares at an exchange or withdrawal; proposal to reduce capital; the initiative to start or stop lasting alliances; substantial participation (&gt; 25% of share capital); investments with a substantial interest; proposals to change the firm’s statutes or disincorporation of the firm; notification of bankruptcy or suspension of payments; dismissal or changing the working conditions of large number of employees</td>
</tr>
<tr>
<td>Interlocking general:</td>
<td>Less acting with mandates: recommendation by Peters Committee; implementation by 80-120 firms</td>
</tr>
<tr>
<td>Monitoring:</td>
<td>Board committees: audit committee, remuneration committee, nomination committee</td>
</tr>
<tr>
<td>Monitoring general:</td>
<td>More board independence: recommendation by Peters Committee; implementation by &gt;120 firms</td>
</tr>
<tr>
<td></td>
<td>Restrainted number of directorships per board member: recommendation by Committee Peters; implementation by 80-120 firms</td>
</tr>
<tr>
<td>Strategic general:</td>
<td>Explicit attention for strategy (at least annually): recommendation by Peters Committee; implementation by &gt;120 firms</td>
</tr>
</tbody>
</table>
4. Evidence of empirical research
In the following, the available empirical research is clustered according to the indicators.

Structure of the board
In a recent estimate, the number of publicly listed and privately owned firms operating under the structural regime is about 400 (Moerland, 1999). Of this total group about 100 firms are listed on the AEX (Amsterdam Exchange). Non-structure firms have more concentrated share ownership (and smaller firm size) compared to structure firms (large firms), except for the firms that are eligible to the mitigated structural regime (Moerland, 1999: 9). He also states that his research shows clearly that the supervisory board is independent of various stakeholders; it is not clear if board members are independent of each other. De Jong et al. (1999) looked at 134 non-financial firms listed at the Amsterdam Stock Exchange. Their findings indicate that for the case of entrenched firms various defensive mechanisms combined with the “structural-regime” have a negative relationship with firm performance. On the other hand, Chirinko et al. (2000) conclude that Dutch firms that voluntarily adopt the structural-regime perform better. De Jong and Moerland (1999) show that next to the structural regime, the average number of defense instruments used by Dutch firms is 2 as opposed to 6 by US firms. The Dutch Monitoring Committee on Corporate Governance (1998) reviews the instruments to limit the influence of the individual shareholder as follows:

- The issuing of certificates of deposits through an administrative office. This implies that the voting power remains within the administrative office, since holders of certificates transfer their voting rights.
- Block ownership of the major stakeholder over 40 per cent.
- The issuing of priority shares through foundations.
- The issuing of finance prefs. This is a rather weak instrument and not considered to be a real powerful instrument to limit voting rights (see Monitoring Committee, 1998).
- The issuing of preference shares held by a continuity foundation as an anti-takeover instrument.

De Jong and Moerland (1999) show that these defense mechanisms are, to a large extent, substitutes for each other.

Insiders/outsiders
Although legally no insiders (managers) are allowed to have a position on the board, quasi-insiders (experts and other non-employee members who act in the interest of the incumbent management) are allowed to have a position on the board. Postma et al. (1999) actually make a difference between quasi-insiders and outsiders (by using a
sample of 94 listed firms of which 77 under the structural regime); they, however, find no evidence for the effect of the composition of the board on firm performance. Their percentage of outsiders is 84%. Van Gulik et al. (2000) in their empirical research, based on a sample of 85 listed Dutch firms with a two-tier board, find 64% outsiders.

**Size of the board**

De Jong et al. (1998), with a sample of 137 listed Dutch industrial firms, find an average size of the board of 4.9 (minimum 0 and maximum of 11). Postma et al. (1999) in their study find an average size of the board of 4.95 (and standard deviation of 1.83). Maassen (1999) indicates a size of 6 supervisory directors in his sample of 100 listed Dutch corporations. Van Gulik et al. (2000) find that firms facing higher levels of financial resource dependence have larger boards (average size of 9 directors and standard deviation of 3.45).

**Compensation of the board**

Spencer Stuart (1998) indicates that in general, stock options and profit based payments are not frequently granted to supervisory directors (this is in accordance with the recommendations of the Peters Committee): fixed board retainers remain the most important in the Netherlands (p.23). The total compensation of supervisory boards was on average NLG 273,000 in 1997.

**Background of directors**

According to the Peters Committee (1997) the following figures are relevant for all listed Dutch Firms (no investment companies and year 1996): in total 593 different persons have at least one membership of a board; the number of directors with 2 directorships is 69; with 3 directorships is 32, and of at least 3 directorships is 20; and the total number of directors (of listed and not listed firms) in the Netherlands is 6542. Hezewijk and Metze (1998) conclude that about 101 persons (of whom 2 are women) share the power in Dutch corporate networks (criterion: one person has simultaneously at least two functions in management boards and/or supervisory boards). Of those persons who followed an academic study, most of them studied economics or law (60%). In Gelauff and Den Broeder (1996), the background of seats in supervisory boards are presented: 36% from industrial firms; 26% are distinguished experts (politicians, lawyers, professors, and former directors); 14% are large shareholders; 13% are financial intermediaries; and 11% are employee representatives. Moreover, Chirinko et al. (2000) find that in 25% of their sample of 165 listed Dutch firms (non financials and non service firms) a network connection exists between the supervisory board or management board of a firm and a supervisory board or management board of a financial intermediary firm. This
percentage is consistent with De Jong (1998), who finds 24% bankers on the boards of his sample (of 102 listed firms).

**Board committees**

In his sample of 100 listed Dutch corporations Maassen (1999) found that at least 45 supervisory boards had one or more board committees in 1997. 42 (%) have a remuneration committee, 32 (%) have an audit committee, and 23 (%) have a nomination committee. His research also indicates an important reason for not using committees at all, namely the relatively small size of the supervisory boards. On average 1 manager is member of the audit- and 1 of the nomination committee, the remuneration committee has on average no manager(s) as a member\(^\text{11}\).

This section is summarized in table 4

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\(^{11}\) According to Maassen (1999), committees in in one-tier structure are predominantly composed of only non-executive directors to stress the monitoring function. His research suggests that in the two-tier structure of Dutch supervisory boards, management participation in the supervisory board committees indicates a mixed composition of both outsiders and insiders.
Table 4 : Characteristics and their scores from Dutch empirical evidence

<table>
<thead>
<tr>
<th>Characteristics</th>
<th>Scores</th>
</tr>
</thead>
<tbody>
<tr>
<td>No. of firms under structural regime:</td>
<td>- 400</td>
</tr>
<tr>
<td>Structural regime compared to non structural regimes:</td>
<td>- Less concentrated ownership in firms under structural regime</td>
</tr>
<tr>
<td>Firms with structural regime:</td>
<td>- Board members are independent of stakeholders (not clearly independent of each other)</td>
</tr>
<tr>
<td></td>
<td>- Have negative and positive relationship with corporate performance</td>
</tr>
<tr>
<td></td>
<td>- Have average number of defense mechanisms of 2</td>
</tr>
<tr>
<td>(Quasi)insiders/outsiders:</td>
<td>- 64-84% outsiders</td>
</tr>
<tr>
<td></td>
<td>- No effect on performance</td>
</tr>
<tr>
<td>Size of the board:</td>
<td>- Average 5-9 members</td>
</tr>
<tr>
<td>Board compensation:</td>
<td>- Few stock options and profit based payments</td>
</tr>
<tr>
<td></td>
<td>- Average NLG 273,000</td>
</tr>
<tr>
<td>Background of directors:</td>
<td>- 593 persons have at least 1 directorship, 69 persons have at least 2 directorships, and 32 persons have at least 3 directorships</td>
</tr>
<tr>
<td></td>
<td>- 101 persons (of all firms) share the network-power in Dutch corporate firms</td>
</tr>
<tr>
<td></td>
<td>- 25% of firms have network connections with financial firms</td>
</tr>
<tr>
<td>Board committees</td>
<td>- Remuneration committee: 42%</td>
</tr>
<tr>
<td></td>
<td>- Audit committee: 32% (including 1 manager)</td>
</tr>
<tr>
<td></td>
<td>- Nomination committee: 23% (including 1 manager)</td>
</tr>
</tbody>
</table>

5. Discussion

The picture that emerges from the literature research is the following. Dutch listed firms who adopt the structural regime have a two-tier board, with (often) three committees (audit, remuneration, nomination). As a consequence of this, there is no CEO-duality. The directors choose each other, by means of co-option (and no co-determination by workers/unions or shareholders). Individual members of the board have an increasing incentive to act to the best of their knowledge, guided by the legally based principle of acting to the ‘best overall interests’ of the firm. They,
generally do not act with mandates from certain stakeholders, but have their own responsibilities. Firms under this regime show less concentrated ownership compared to others. Reputational effects, are increasingly (and legally) underlined. Members are also independent of other board- and management team members. The supervisory board both initiates and evaluates (ratifies) strategic decisions. In general, (practically) no insiders are allowed in the supervisory board. This is mainly a consequence of Dutch law in this respect. The minimum size of the supervisory board is three (legally determined), the average size is five to nine directors. Few stock options and profit based payments are applied. Network research shows that informal networks of directors (and managers) govern the Dutch corporate (listed) world. In this respect, the situation in Dutch firms resembles the German bank-influenced situation.

By using an adapted definition of insiders and outsiders, Postma et.al. (1999) try to relate board composition to firm performance. Their research shows no clear results, although Van Gulik et al. (2000) indicate a significant correlation between the numbers of outsiders and some performance measures. Apparently no conclusive results can be found for the Dutch situation. Perhaps this is not quite surprising, as we observed in section 2.4, the literature on this topic has produced rather mixed evidence as regards to the impact of outsiders in supervisory boards. The (non) results of the meta-study of Dalton et al. (1998) are in this respect confirmed. Next, the findings of Maassen (1999) can be mentioned. He discusses also the composition of board committees. Besides non-executive directors, audit- and nomination committees are also manned by at least one manager. This means that the monitoring function of these committees might be reduced (at least disturbed) and by that the entrenchment of management might be stimulated. This is even more enhanced by the common practice that Dutch supervisory boards generally meet together with managing directors (Maassen, 1999).

Dutch listed firms with a structural regime, in combination with other defense mechanisms, tend to show a negative relationship with performance, although this finding needs to be considered with care (c.f. Chirinko et al., 2000). These firms also have less defense instruments, compared to the US-situation. De Jong and Moerland (1999) indicate that the various defense mechanisms used in the Dutch situation are mainly substitutes for each other. This supports the findings of La Porta et al. (1998) about the relatively low score on shareholder protection in the Dutch situation and also indicates the importance of the supervisory board, as an alternative instrument for management board control in the Dutch situation. The structural regime is a defense mechanism in itself. This suggests that management boards in Dutch firms with a structural regime (because of the co-option principle) are entrenched and well protected against hostile actions or takeovers from shareholders. The discussion by the Peters Committee and also momentarily in the Dutch government is particularly aimed at (partly) reversing the negative aspects of this situation; claiming the
necessity of better/more protection of shareholders and the better functioning of financial markets. In that way better accountability and more transparency of the functioning of the supervisory board may be realized.

The most intriguing aspect of the supervisory boards in the structural regime is the co-option principle. Although legally underpinned and having clear advantages, it also leads too much heated discussion. In table 5 the advantages and disadvantages (found in various Dutch sources) are summarized.

Table 5: Advantages and disadvantages of the co-option principle

| ADVANTAGES: |
| - Best interest of the firm is aimed for (not only one stakeholder) |
| - Choice of experienced directors and experts in their field |
| - Protection against hostile take-over |

| DISADVANTAGES: |
| - ‘Best interest’ is ill defined |
| - Shareholders are ill protected |
| - Possibly negative influence on financial markets |
| - Too much like-mindedness/consensus (groupthink) |
| - Possibly collusion with management boards |
| - Poor quality attracts poor quality: how to get rid of them? |

Raaijmakers and De Ridder (1996) warn for the possibility of too much like-mindedness and resulting consensus. Also, collusion with the management board is possible. The agency-problem (see section 1) is thus replaced by the co-option problem. Gelauff and Den Broeder (1996), state that the system of co-option limits the influence of shareholders. In their opinion, this implies that the quality of internal control is heavily dependent on the supervisory board members themselves. In firms with an incompetent supervisory board this may lead to the selection of congenial members. Gelauff and den Broeder therefore expect that the Dutch supervisory board may be of less uniform quality compared to its German counterpart (p.361). The discussion therefore focuses on the balancing of the advantages against the disadvantages. The Peters Committee recommends that the position of the shareholders must be improved (for instance by means of proxy solicitation) and the role of the boards more circumscribed. In our opinion this might not be enough. Next to more accountability of the supervisory board to the shareholders or stakeholders in general, an independent composition of the board might be a solution. In that way the existing co-option might be improved. With independence, we especially refer to being independent from other stake/shareholders and management. The ‘old-boys’ network may not be changed, but we would strongly recommend to choose directors according to their experience, expertise, and resource connecting capabilities. To the
extent that financial markets are efficient, an alternative option might be to increase the influence of external stake- or shareholders (e.g. in the General Meeting of shareholders) on the composition and functioning of the supervisory board (c.f. Moerland, 1997).

6. Concluding remarks
The three functions of the supervisory board in the Netherlands are respectively the interlocking function, the monitoring function, and the strategic function. For all three functions supporting theories are discussed, followed by relevant aspects that operationalize these theories. In supervisory boards in the Netherlands, support for the prevalence of these three functions can be found. The effectiveness of the Dutch supervisory board is questioned because of the fact that, in case of a structural regime in combination with other defense instruments, possible adverse effects on performance may show up. This is mainly a consequence of the two edged sword of co-option and the resulting ill-protection of stakeholders.

The monitoring function is the most traditional function of the board. This function is at the one hand enhanced by the two-tier system (no CEO-duality) and the relatively large number of outsiders. Supervisory board members theoretically can act independently from other stakeholders. On the other hand, they may be influenced by management, because they have joint meetings (e.g. in committees) and because of the possibly negative side-effects of co-option, which may ultimately result in distortion of the monitoring function. The interlocking function becomes relevant in situations in which the dependence of the external environment shows up. This function is clearly visible in that the number of outsiders is relatively large, reputational consequences are important, co-option of experts and intermediaries is possible, many directors have more than one directorships or top management function, and 25% of firms have network connections with financial firms. The strategic function is gaining in relevance, because increasingly the strategic and competitive value of the initiative, advice, and second opinion of board members in these matters is recognized (Vance, 1983; Charan, 1998; Davies, 1999). A possible problem in this case may be that sometimes the borderline between decision management and decision control is crossed. Especially in the case of venture capitalists and other stakeholders, who also perform a supervisory role. In that situation the following question may be put forward: who is responsible for what? Based on the preceding discussion about the functions and problems related to co-option, we expect that the relation between the three functions and performance might be moderated by the various corporate governance options. Table 6 shows the expected relationships and the direction of the effects.
Table 6: Relationships between functions & performance and moderating effects of corporate governance regimes

<table>
<thead>
<tr>
<th>Functions</th>
<th>Expected relationship between function and performance</th>
<th>Expected moderating effect two-tier with co-option (structural regime)</th>
<th>Expected moderating effect two-tier without co-option (common regime, German system)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Interlocking</td>
<td>+</td>
<td>+</td>
<td>+</td>
</tr>
<tr>
<td>Monitoring</td>
<td>+</td>
<td>-</td>
<td>+</td>
</tr>
<tr>
<td>Strategic</td>
<td>+</td>
<td>+</td>
<td>+/-</td>
</tr>
</tbody>
</table>

As a bottom-line case, we expect a positive relationship between the three functions and firm performance (see also section 2.4 and figure 2). We expect in both alternative cases a positive influence on the relationship of the interlocking function and performance, because of the high number of outsiders and positive network effects. Because of the possibly dominant negative side-effects of co-option in the structural regime, the relationship between monitoring and performance might be adversely affected, as opposed to the common regime (without co-option) or the German board system. We expect that the structural regime deals more effectively with dynamic environments compared to the alternative regime(s). Because of the possibility that in this regime co-option leads to the inclusion of more experienced directors and better experts in the board, a positive moderating effect on the relationship between the strategic function and performance in the structural regime might show up. In the alternative regime(s), board members are expected to be included from a stakeholder position, and consequently may have some adverse effects on board performance.

Further research into these three functions is necessary to establish the value added of the supervisory board vis-à-vis the management board. Also, comparisons with the one-tier board may be insightful in order to arrive at more definitive conclusions. The functions are also all related to each other. For instance, the question "how do boards draw the line between monitoring performance and managing the company" still remains to be answered (Lorsch, 1995).

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12 The Anglo-Saxon model might even be better in competitive and fast changing environments (Gelauff and Den Broeder, 1996).
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