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The Role of the Board in Corporate Governance

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The role of the Board in corporate governance

Introduction

Exactly one year ago, on 7 September 2004, the Dutch Minister of Justice sent a document to Parliament explaining his views and intentions with respect to modernizing Dutch company law.

The Minister of Justice indicated that modernization is necessary. There is competition between company forms in Europe and abroad. When a company is incorporated or restructured, decision makers can often choose between different national entities (private and public companies), but also between national and foreign entities (Dutch company forms or other, for example UK, company forms). Our aim should be to create reliable but also flexible – and therefore competitive - Dutch company forms.

The Minister of Justice explained that we should aim at a legal infrastructure which:

- offers company forms that are flexible enough to adapt to the wishes of decision makers;
- offers company forms that have good checks and balances with respect to the role and responsibilities of the board and shareholders;
- will promote transparency through the availability of reliable financial information;
- will prevent misuse of company law (hiding behind the company veil) and has sufficient and effective public oversight;
- includes an even more efficient judicial system.

Checks and balances

Good corporate governance requires good checks and balances. In large Dutch companies this requires a good balance of the role of the management board, the supervisory board and the AGM. Traditionally Dutch listed companies have a two-tier board structure. This tradition dates back to the days of the United East Indian Company (VOC), when Dutch shareholders wanted to be able to check the Dutch management of its overseas activities. At that time supervisors were appointed and brought together in a separate organ of the company, the supervisory board. The supervisory directors should act in the (long term) interest of the company. The alternative would have been to appoint more managers (to check the others, i.e. introducing a one-tier board with non-executive members), but that choice was not made.

Since the 1970 the role of the supervisory board became more and more pronounced. The legislator relied more and more on the supervisory directors to check and advise the managing board, as minority shareholders were thought to lack the voting power to influence the decision making process and the knowledge to make an informed decision. For some large companies an obligation to have a supervisory board was introduced. Shareholders and employees were both given a certain influence on the appointment of supervisory board members in that case.

In time the focus changed, due to accounting scandals in the USA and in Europe. We still believe that the supervisory directors have an important role in the company, as they should keep the long-term interest of the company as a whole in mind; something one can not expect from shareholders. But we learned that it is not enough just to have a supervisory board of directors. The supervisors should also be active and competent. They should not all be part of the same old boys network of former managing directors. In order to improve the checks and balances in corporate governance, the Minister of Justice tried to ensure that shareholders would in the future have more information from the management board and supervisory board about the results of the company and the activities of the members of both boards. There should be more transparency. This should enable shareholders to be more active in the AGM and to check both the board of managing directors and the board of supervisory directors in the exercise of their respective roles. Also the risk of conflicts of interest of board members would be reduced. In addition we gave new, additional rights to shareholders.

Some examples of what we have done:

1. As of 2002, most public companies must make public in their annual accounts remuneration paid to and shareholdings of all members of the managing board and supervisory board. This information must be provided per person, i.e. the remuneration paid to every individual member of the board.
2. As of 2004, public companies must have a remuneration policy, that is adopted by the shareholders. The remuneration paid to board members must be consistent with this policy. In most Dutch listed companies the supervisory board decides about the remuneration of the managing board. The supervisory board is bound by the remuneration policy of the shareholders.
3. Also as of 2004, the managing board of public companies must ask the approval of the shareholders for certain major decisions, i.e. decisions that might change the identity or character of the company. For example, the law provides that approval must be asked in case of transfer of all (or most of) the assets and liabilities of the company to a third party, or in case a joint venture is considered or ended (if that has a major influence on the company).
4. Shareholders of public and private companies now have the right to put items on the agenda of the AGM if they represent at least 1% of the share capital. If a shareholder of a listed company does not represent 1% of the share capital, but his shareholding does represent a value of at least 50 million euro, he can also put items on the agenda.

Board structure of public companies

When aiming at good checks and balances and at flexibility of company forms, the Minister of Justice also had to look at the board structure of Dutch companies. There is flexibility when the company can structure the company in a way that is best for business according to the board and the shareholders.

This structuring can be done in the articles of association. On the other hand, this flexibility must be limited. Shareholders and creditors must be able to rely on certain rules, for example regarding capital maintenance. Also good supervision of management should be ensured.

In order to ensure good supervision of management, the Netherlands have a compulsory two-tier board system for certain large companies (so-called structural regime). If the regime is applicable, supervisory directors are appointed by the AGM via a complicated procedure, based on influence of both shareholders and employees. There is an ongoing discussion whether this system should be amended in such a way that the influence of employees is re-characterised, as the system is - according to some - difficult to explain to investors from abroad.

However, I do not have to go into that discussion as most listed companies are exempted from the obligation to comply with the structural regime; important exemptions of the structural regime are in place for Dutch holding companies and Dutch companies that are part of an international group of companies.

As a consequence, most listed companies are free to introduce either a two-tier board or a one-tier board structure, in which case a single board contains both executive and supervisory (non-executive) directors.

Most Dutch listed companies opt for the two-tier system. The companies and their investors are familiar with a two-tier board and feel comfortable with it. A few listed companies in the Netherlands have a one-tier structure (Fortis N.V., Unilever N.V.). This is probably due to the fact that they have many investors that are more familiar with that structure.

As companies may opt for either board structure, the question is which considerations they could take into account. It is often said that an advantage of a one-tier board structure is that the non-executive directors are in general very well informed. They meet regularly and join the executive directors in board meetings. As a result of this the non-executive directors are informed about the day to day business. Also, the non-executive directors are more involved in short-term decisions / general management decisions than supervisory board members in a two-tier structure. On the other hand, the more regular involvement of non-executive directors in board meetings may make it more difficult to differentiate between the role of non-executive board members and executive board members. If there is no clear dividing line between the duties and responsibilities of executive and non-executive board members, this might easily lead to liability of the non-executives (if they know about problems, they should act accordingly) while this problem does not exist for the supervisory directors in a two-tier board structure.

In The Netherlands, companies have requested the Minister of Justice to clarify in statutory law the duties and responsibilities of non-executive board members in a one-tier board structure. It should be

clarified that the articles of association may provide that executive and non-executive directors have a different role, i.e. different duties and responsibilities. It should also be clarified that non-executive directors are in general not liable for the duties of the executive directors. This request is related to the fact that in the Netherlands all members of the management board are jointly responsible and liable for all activities of the board. We are currently working on a new bill to respond to this request.

Members of a supervisory board in a two-tier system will in general meet less often and will – at least sometimes – meet separate from the management board. The duties and responsibilities of the supervisory board members are sufficiently defined in statutory law and the Dutch corporate governance code. We feel that these separate meetings of the supervisory board will help the supervisory directors to focus on the long-term interests of the company and also to act independently from the management board. This could be considered an advantage of the two-tier system. The problem in a two-tier system is how to get sufficient information about the activities of the management board in the supervisory board, in order to supervise and advise the management board in an informed and responsible manner. To solve this problem, supervisory board members must have the right to ask the members of the management board for all information that the board requires to do its job properly. There remains a risk that supervisory board members are not active enough, but such members risk liability due to negligence.

Within the Ministry of Justice we are of the opinion that the one-tier board structure and the two-tier board structure are converging in practice. The differences are becoming smaller. In the one-tier structure the request to the legislator is to clarify the difference between the duties and responsibilities of executive and non-executive directors (to avoid liability of the non-executives). In the two-tier system we expect the supervisory board members to be more active than they were in the past, and if they are not, they are declared liable. In both systems it is crucial that non-executive directors and supervisory directors act independently, are competent and decide in an informed manner. We do not believe that the one-tier system or the two-tier system causes such problems that we should abolish the option for our listed companies to choose between either system. In practice we have no major problems with the two-tier system, but the one-tier system can be improved. This will require additional legislation with respect to the liability of non-executive board members. The possibility to choose between a one-tier and a two-tier-board, is part of the flexible company law system that the Minister of Justice wants to offer.

Dutch code on corporate governance

Connected to flexible company law is the Dutch code on corporate governance. The Minister of Justice is of the opinion that we should not over-regulate via statutory law. Statutory law should only intervene where it is necessary to change practices or attitudes. Statutory law should also enable the shareholders to make their decisions in an informed manner. However, where self regulation is sufficient, the legislator should not interfere.

In December 2003 the Dutch corporate governance code was presented. The code was drawn up by a committee, at the request of Euronext Amsterdam, The Netherlands Centre of Executive and Supervisory Directors, The Foundation of corporate governance research for pension funds, the association of stockholders, the association of securities-issuing companies and the confederation of Netherlands industry and employers. The code is an example of self-regulation by the business community.

The code contains provisions which persons involved in a Dutch listed company (including the management board members and supervisory board members) and stakeholders (including institutional investors) should observe in relation to one another. Based on the code, the company should state in its annual report how it has applied the provisions of the code in the past financial year.

However, past experiences with self-regulation regarding good corporate governance, were reason for the Dutch government to provide a statutory basis for the code and its application. The Minister of Justice provided that – from the 2004 financial year onwards - Dutch listed companies have to include in their annual report a section on their corporate governance and compliance with the provisions of the code, in as far as the code contains obligations for the board. In case of non-compliance, the companies should explain to the shareholders why they did not comply with the code (“comply or explain”). It is up to the shareholders to decide whether they accept the non-compliance and the reasons given. This gives flexibility to the company.

The Authority Financial Markets will check whether listed companies have included a section on application of the code in their annual report. Furthermore, the Dutch government has put a monitoring committee in place, to check the results of the code and to report to the government. We must wait and see what will happen and will decide later on whether additional regulation is necessary.

I copied several provisions of the Dutch corporate governance code in an Annex. These provisions deal with the responsibilities of board members, their remuneration, the way they should act when there is a conflict of interest with the company, their education, the fact that they should not sit on too many boards. The provisions also deal with the independence of supervisory directors in a two-tier system and of non-executive directors in a one-tier system. I can come back to all of these provisions when there is sufficient time left. However, I would now like to focus on the provisions in the code (III.8) that deal specifically with the one-tier board structure and the proper and independent supervision by the non-executive directors.

The code provides that the chairman of the one-tier board should not be an executive director. This means that the CEO should not also be the chairman of the board. The reason for this provision is that the CEO and the chairman of the board have different responsibilities. The CEO is responsible

for the operational management, whereas the chairman is responsible for the functioning of the board, including proper supervision of management (among which the CEO). There is a conflict of interest when chairman and CEO are the same person. Furthermore, if the CEO is the chairman of the board, there is a risk that he has too much influence on the agenda of board meetings and the provision of information about the company to the non-executive directors.

The chairman should also not be a person who was an executive director in the past. Such a former role of the chairman may also hinder an independent supervision of the executive directors.

Furthermore, the code provides that the majority of the one-tier board should consist of non-executive directors, who are independent within the meaning of the code. The idea is that this will help the board to focus on the long term interests of the company instead of the short term interests of the executive directors.

I mentioned earlier that the company must declare in the annual report whether it complies with the code, or explain why it does not. The law therefore allows deviation from the code and it is up to the shareholders to decide whether they feel that the supervision of the one-tier board in their company is well organized. It is up to the shareholders to decide whether they accept deviation from the code, based on information provided in the annual report.

Conclusion

I hope this gives some insight in recent developments in the Netherlands. As mentioned before, I do not think that the Minister of Justice will force our listed companies to choose for either the one-tier or the two-tier board structure. They should decide themselves which structure suits them best. However, with statutory regulations and the corporate governance code we do try to strengthen both systems, to clarify for managers and their supervisors what their duties and responsibilities are.

The chairman of the drafting committee of the Dutch corporate governance code, Mr. Morris Tabaksblat, once said that the ideal supervisory director is “competent, committed, constructive and critical”. I think this also applies to the non-executive director in the one-tier board.

I thank the chairman for giving me the floor.

Annex

From: Dutch corporate governance code

Principles of good corporate governance and best practice provisions

II. Management board

II.1 Role and procedure

Principle:

The role of the management board is to manage the company, which means among other things, that it is responsible for achieving the company's aims, strategy and policy, and results. The management board is accountable for this to the supervisory board and to the general meeting of shareholders. In discharging its role, the management board shall be guided by the interests of the company and its affiliated enterprise, taking into consideration the interests of the company's stakeholders. The management board shall provide the supervisory board in good time with all the information necessary for the exercise of the duties of the supervisory board.

The management board is responsible for complying with all relevant legislation and regulations, for managing the risks associated with the company activities and for financing the company. The management board shall report related developments to and shall discuss the internal risk management and control systems with the supervisory board and its audit committee.

Best practice provisions

II.1.1 A management board member is appointed for a maximum period of four years. A member may be reappointed for a term of not more than four years at a time.

[...]

II.1.4 The management board shall declare in the annual report that the internal risk management and control systems are adequate and effective and shall provide clear substantiation of this. In the annual report, the management board shall report on the operation of the internal risk management and control system during the year under review. In doing so, it shall describe any significant changes that have been made and any major improvements that are planned, and shall confirm that they have been discussed with the audit committee and the supervisory board.

[...]

II.1.7 A management board member may not be a member of the supervisory board of more than two listed companies. Nor may a management board member be the chairman of the supervisory board of a listed company. [...]

II.2 Remuneration

Amount and composition of the remuneration

Principle:

The amount and structure of the remuneration which the management board members receive from the company for their work shall be such that qualified and expert managers can be recruited and retained. If the remuneration consists of a fixed and a variable part, the variable part shall be linked to previously-determined, measurable and influenceable targets, which must be achieved partly in the short term and partly in the long term. The variable part of the remuneration is designed to strengthen the board members' commitment to the company and its objectives.

The remuneration structure, including severance pay, is such that it promotes the interests of the company in the medium and long term, does not encourage management board members to act in their own interests and neglect the interests of the company and does not "reward" failing board members upon termination of their employment. [...]

Best practice provisions

[...]

II.2.3 Shares granted to management board members without financial consideration shall be retained for a period of at least five years or until at least the end of the employment, if this period is shorter. [...]

II.2.7 The maximum remuneration in the event of dismissal is one year's salary (the "fixed" remuneration component). If the maximum of one year's salary would be manifestly unreasonable for a management board member who is dismissed during his first term of office, such board member shall be eligible for a severance pay not exceeding twice the annual salary.

II.2.8 The company shall not grant its management board members any personal loans, guarantees or the like unless in the normal course of business and on terms applicable to the personnel as a whole, and after approval of the supervisory board. No remission of loans shall be granted.

Determination and disclosure of remuneration

Principle

[...] The supervisory board shall determine the remuneration of the individual members of the management board, on a proposal by the remuneration committee, within the scope of the remuneration policy adopted by the general meeting of shareholders.

Best practice provisions

[...]

II.2.11 The main elements of the contract of a management board member with the company shall be made public immediately after it is concluded. These elements shall in any event include the amount of the fixed salary, the structure and amount of the variable remuneration component, any redundancy scheme, pension arrangements and performance criteria.

II.3 Conflicts of interest

Principle

Any conflict of interest or apparent conflict of interest between the company and management board shall be avoided. Decisions to enter into transactions under which the management board members would have conflicts of interest that are of material significance to the company and/or to the relevant management board member require the approval of the supervisory board.

[...]

III. Supervisory board

III.1 Role and procedure

Principle

The role of the supervisory board is to supervise the policies of the management board and the general affairs of the company and its affiliated enterprise, as well as to assist the management board by providing advice. In discharging its role, the supervisory board will be guided by the interests of the company and its affiliated enterprise, and shall take into account the relevant interests of the company's stakeholders. The supervisory board is responsible for the quality of its own performance.

Best practice provisions

[...]

III.1.6 The supervision of the management board by the supervisory board shall include:

- (i) achievement of the company's objectives;
- (ii) corporate strategy and the risks inherent in the business activities;
- (iii) the structure and operation of the internal risk management and control systems;
- (iv) the financial reporting process;
- (v) compliance with the legislation and regulations.

[...]

III.1.7 The supervisory board shall discuss at least once a year on its own, i.e. without the management board being present, both its own functioning and that of its individual members, and the conclusions that must be drawn on the basis thereof. [...] Moreover, the supervisory board shall discuss at least once a year without the management board being present both the functioning of the management board as an organ of the company and the performance of its individual members, and the conclusions that must be drawn on the basis thereof. Reference to these discussions shall be made in the report of the supervisory board.

[...]

III.1.9 The supervisory board and its individual members each have their own responsibility for obtaining all information from the management board and the external auditor that the supervisory board needs in order to be able to carry out its duties properly as a supervisory organ. If the supervisory board considers it necessary, it may obtain information from officers and external advisers of the company. The company shall provide the necessary means for this purpose. The supervisory board may require that certain officers and external advisers attend its meetings.

III.2 Independence

Principle

The composition of the supervisory board shall be such that the members are able to act critically and independently of one another and of the management board and any particular interests.

Best practice provisions

III.2.1 All supervisory board members, with the exception of not more than one person, shall be independent within the meaning of best practice provision III.2.2.

[...]

III.3 Expertise and composition

Principle

Each supervisory board member shall be capable of assessing the broad outline of the overall policy.

[...]

Best practice provisions

[...]

III.3.2 At least one member of the supervisory board shall be a financial expert, in the sense that he has relevant knowledge and experience of financial administration and accounting for listed companies or other large legal entities.

III.3.3 After their appointment, all supervisory board members shall follow an introduction programme, which, in any event, covers general financial and legal affairs, financial reporting by the company, any specific aspects that are unique to the company and its business activities, and the responsibilities of a supervisory board member. [...]

III.3.4 The number of supervisory boards of Dutch listed companies of which an individual may be member shall be limited to such an extent that the proper performance of his duties is assured; the maximum number is five, for which purpose the chairmanship of a supervisory board counts double.

III.3.5 A person may be appointed to the supervisory board for a maximum of three 4-year terms.

III.4 Role of the chairman of the supervisory board and the company secretary

[...]

Best practice provisions

[...]

III.4.2 The chairman of the supervisory board shall not be a former member of the management board of the company.

[...]

III.5 Composition and role of three key committees of the supervisory board

Principle

If the supervisory board consists of more than four members, it shall appoint from among its members an audit committee, a remuneration committee and a selection and appointment committee. The function of the committees is to prepare the decision-making of the supervisory board. [...]

III.6 Conflicts of interest

[...]

Best practice provisions

[...]

III.6.2 A supervisory board member shall not take part in a discussion and/or decision-making on a subject or transaction in relation to which he has a conflict of interest with the company.

III.7 Remuneration

Principle

The general meeting of shareholders shall determine the remuneration of supervisory board members. The remuneration of a supervisory board member is not dependent on the results of the company. [...]

Best practice provisions

III.7.1 A supervisory board member shall not be granted any shares and/or rights to shares by way of remuneration.

III.7.2 Any shares held by a supervisory board member in the company on whose board he sits are long-term investments.

[...]

III.7.4 The company shall not grant its supervisory board members any personal loans, guarantees or the like unless in the normal course of business and after approval of the supervisory board. No remission of loans shall be granted.

III.8 One-tier management structure

Principle:

The composition and functioning of a management board comprising both members having responsibility for the day-to-day running of the company (executive directors) and members not having such responsibility (non-executive directors) shall be such that proper and independent supervision by the latter category of members is assured.

Best practice provisions

III.8.1 The chairman of the management board shall not be and shall not have been an executive director.

III.8.2 The chairman of the management board shall check the proper composition and functioning of the entire board.

III.8.3 The management board shall apply chapter III.5 of this code. The committees referred to in chapter III.5 shall consist only of non-executive management board members.

III.8.4 The majority of the members of the management board shall be non-executive directors and are independent within the meaning of best practice provision III.2.2.