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Compliance management and system based supervision

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SUMMARY

This paper describes the backgrounds and experiences of a project by the Province of Noord-Brabant (Netherlands) involving a new form of supervision: system based supervision (SBS). The aim of SBS is to use the quality of self regulation of big industrial companies for the purpose of customizing supervision and improving compliance by assessing their compliance management system. Public supervisors of the Province use an audit methodology to assess the company's level of internal control regarding regulatory compliance and risk management. If the compliance management system meets the set standards, the company is inspected less frequently. SBS contributes to a more professional relationship between the supervising organization and the regulated company. The paper explains the preconditions for system based supervision and discusses the experiences and pitfalls of the project.

1. INTRODUCTION

This paper is about compliance assurance through company compliance management systems and is based mainly on a project by the Province of Noord-Brabant (hereafter the province). The authors have been involved in this project.

The province is charged with the supervision of big industrial companies in terms of their compliance with environmental legislation.

Law enforcement was long driven by the principle: "trust is good, control is better." This principle, however, does not do justice to companies and people that pay attention to proper compliance with legal requirements. The assurance of compliance requires a supportive corporate culture and also an investment in an effective management system. The province holds the opinion that companies with a good record in compliance management deserve more trust. We have therefore adjusted the principle of enforcement to: confidence whenever possible.

First, we explain the theoretical backgrounds of assuming trust as a basis for inspections and compliance competence. Second, we show the possibilities of this new form of supervision and the preconditions required. Third, we discuss the experiences in the Netherlands and especially in the province. We end this paper with conclusions and recommendations for working with this new way of supervision.

Before focusing on system based supervision (SBS), we will first explain why the province has chosen for a different approach to supervision. Compliance with regulations is a time and money consuming task. Especially when the government produces more and more rules as a consequence of perceived risks (Better Regulation Commission 2006). While the province wants to improve the quality of its enforcement wherever possible, it also pursues a smarter approach aimed at reducing the inconvenience for regulated companies. Also, it wants to end the trend of imposing ever-more rules and regulations, and instead restore focus on the underlying goal: the reduction of social risks. It is obvious that this approach requires other competencies of both individual law enforcers and the entire organization.



COMPLIANCE MANAGEMENT SYSTEMS

Management systems used by private companies are generally focused on optimizing operational aspects of business like quality, health, safety and the environment. Companies with management systems have a large potential to ensure compliance with legal requirements in their own organization and contacts (the so-called compliance management). This potential is seldom or not used by law enforcers because the existing standards for management systems are not specifically aimed at securing compliance with legal requirements. There are therefore significant differences in compliance results among companies working with certified management systems. And, the other way around, legislation does not anticipate management systems. The province wants to close the gap between (the aims of) regulations and management systems.

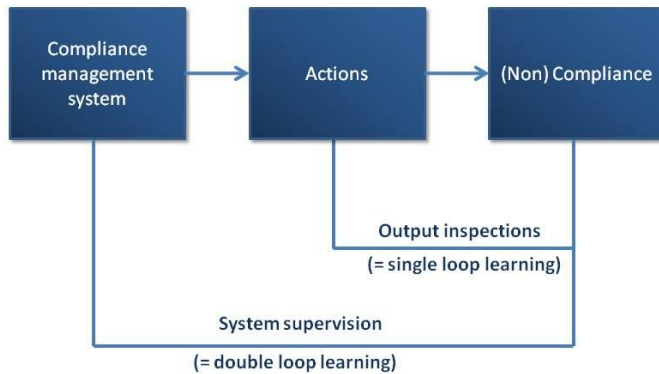
Quality management is aimed at two elements, namely the assurance of quality and continuous improvement of quality. Assurance means that a certain stable level of quality is achieved by taking specific organizational measures. The second element relates to the learning ability and is meant to maintain an ongoing process of improvement of quality through cycles of plan, do, check and act. The basis for compliance management is that these two principles are used specifically to achieve that regulated companies assure and continuously improve regulatory compliance. The fact that a regulated company operates an effective compliance management system, has implications for the role of the law enforcer. For the purpose of this paper, a compliance management system is defined as an internal management system used by a company, which is explicitly aimed at preventing the company from violating legal requirements and permit conditions (Huizinga et al. 2009).

Following this introduction of company compliance management systems, it is important to clarify some other concepts and definitions. We differentiate between SBS and output inspections. The distinction between SBS (also referred to as meta-regulation) and output inspections can be explained using a model of learning in organizations.

In the traditional supervision approach, the regulator verifies whether or not output meets the legal standards. Thus, it is considered whether emissions exceed the standards, or certain technical provisions are met, and so on. This way of supervision is aimed at assessing the output and only results into actions of the company to end the violation. The learning effect is limited and has a shallow or so called single loop character (Argyris, 1978). For example, a company that violates an emission limit of mercury into the air is forced to take measures to stop the emission, but is not necessarily compelled to examine the causes of the emission. The issue of how the management system failed to prevent the emission and how the internal controls have performed are not questioned. The latter is exactly what system supervision does.

System supervision brings about a deeper form of learning (double loop learning) because it focuses on the underlying processes, strategies and procedures that aim to achieve regulatory compliance. System supervision thus intervenes in the structural causes of compliance and non-compliance and therefore brings about a structural improvement in compliance management. The combined efforts of system supervision and output inspections are called SBS.

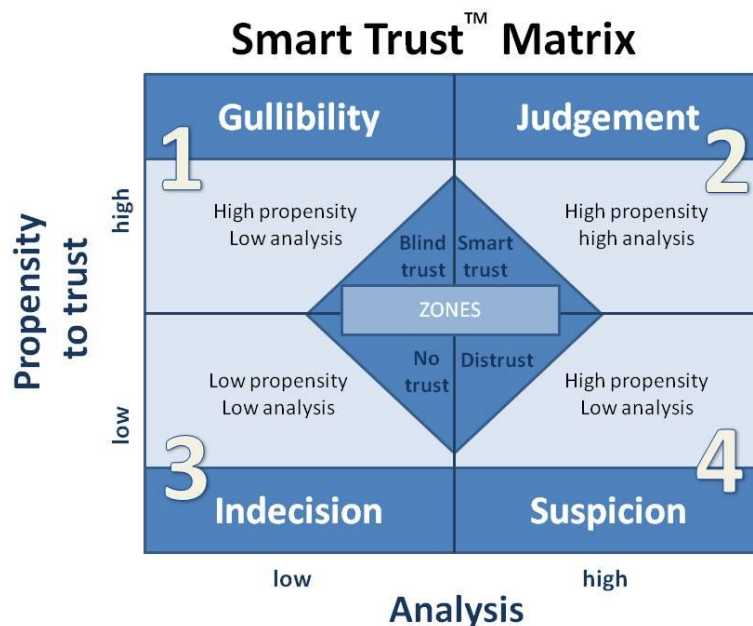
Figure 1 Model for system based supervision



TRUST AS A BASIS

Trust forms an important aspect of the strategy. It is commonly recognized that trust leads to efficiency because of less monitoring and less transaction costs (Fukuyama 1995) and is expected to lead to better compliance (De Goffau 2008, Gunningham et al. 2009, Huizinga et al. 2009). Trust as a concept however is too undistinct to use as such in a practical supervision strategy. It requires operationalization to benefit from the system dynamics (Six 2010) to improve effectiveness. Covey (2008) distinguishes between trust based on little or no analysis, and trust based on analysis, thus making a difference between being naïve and justified trust. We believe that the statement “giving confidence wherever possible” means that confidence should be given only in those situations in which it is justified by the facts.

Figure 2 Trust Matrix (Covey, 2008)



To further operationalize the concept of trust and to materialize the smart trust mentioned by Covey, we use the formula below (Benninga 2007).



$$\text{Trust} = \frac{\text{credibility} \times \text{quality of relationship} \times \text{reliability}}{\text{conceit}}$$

This formula offers four specific aspects that every party participating in a particular relationship can work on to increase trust. In a supervisory relationship, trust is borne from the fact that regulatory compliance is sufficiently assured, and improved where necessary. These above-mentioned four factors of trust are used to develop criteria for compliance management systems. In this way, we have been able to create a measure for compliance management, thus operationalising trust. In the next paragraph, we will explain which specific features of the management system are assessed and the four levels of compliance competence recognized by the province.

LEVELS OF COMPLIANCE COMPETENCE

The province has defined standards for four levels of compliance management according to which companies can be classified:

1. Companies that do not want to and/or cannot manage regulatory compliance. These companies are not willing to manage compliance or not able to manage compliance because of the lack of competencies. These companies are unfamiliar with the principles of quality management.
2. Companies with a certified or certifiable management system in accordance with, for example, the ISO 9001 or 14001/EMAS (Eco Management and Audit Scheme). These companies have verifiably implemented quality management to some extent, but this is not specifically aimed at assuring regulatory compliance.
3. Companies with an effective compliance management system. These companies have a management system that is specifically aimed at assuring regulatory compliance.
4. Companies with a proven compliance management system. These companies have a management system that is specifically aimed at assuring compliance. Also, this compliance management system has shown good results for several years and the company is working on continuous improvement.

The difference between levels one and two is that in level two a company has a management system in operation and in one it doesn't. In level three, a company has a specific compliance management system. This is verified by an audit methodology using a checklist with forty-nine questions and verification items. The audit is performed by or in name of the province as public supervisors. Companies have to score positive on all essential and 50% of the important elements of the checklist. For every element it is checked whether it is fit for purpose, whether it is documented and whether it is implemented.

Level four requires that the system meets additional criteria and that the system meets this level during at least two years.

¹ This checklist is also available as a self assessment tool on <http://www.brabant.nl/systeemtoezicht>

Figure 3 Levels of compliance competence



Each of the four levels of compliance management calls for a different supervision approach (Table 1). When a company is in compliance management level 2, it can be invited to make arrangements about improving to level 3 and 4, in which case supervision is adjusted. This development model shows how companies and regulators can together progress to a higher level by focusing on a better assurance of compliance and appropriate methods of supervision that go with growing trust. In level 4, preventive supervision is limited to a yearly audit and few output samples.

Table 1 Supervision adjusted to the level of the compliance management system

Compliance management level	Preventive supervision	Repressive Company has reacted adequately to a violation*	Repressive Company has not reacted adequately
1	On output	Traditional**	
2	On output + arrangement SBS		
3	On output and system (50/50)	No penalty	Stricter penalty
4	On output and system (20/80)	No penalty	Stricter penalty

* i.e. the regulated company has identified and terminated the violation itself and has taken measures to prevent the violation from occurring again.

** traditional repressive supervision may mean written warning, financial penalty or coercion.

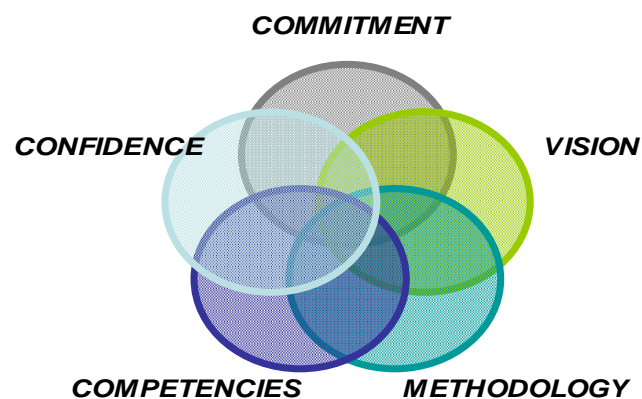


2. WHAT IS NEEDED FOR THIS NEW FORM OF SUPERVISION?

Although some politicians seem to believe that SBS will solve all compliance problems, SBS is not a panacea for everything. Application of system based supervision requires that a number of conditions are met. The overall basic requirement is a positive attitude (commitment) with regard to a targeted compliance management system, both from the company and the government. All people involved in this process need to have and show a positive attitude and believe that a compliance management system is a good foundation for control. For a company this means that commitment is required not only from its manager for safety, health and environment, but also its middle and top management. And equally, on the side of the government, there is the need for an enthusiastic policymaker, a management that understands the methodology and a member of the board of executives who embraces the paradigm that competent companies can actually reduce the risk of environmental damage to an acceptable level by means of compliance management systems. Last but not least, supervisors should understand and work in accordance with the principles of the method.

Starting from a positive commitment towards system based supervision, we can identify the other success criteria for this form of supervision. We have found that the other conditions are confidence², competencies, vision and methodology. As these conditions are inter related, one condition cannot be met without the other. This implies that SBS requires a multi-disciplinary effort, a bit like playing chess on several boards at the same time (see Figure 4).

Figure 4 **The essential ingredients for SBS**



CONFIDENCE

SBS can only be effective if there is a certain minimum level of trust between parties. It is essential to leave the past behind and look forward with an open mind to arising opportunities. It is applicable to those companies that are intrinsically motivated to serve social interests, whether there are legal requirements to do so or not (Braithwaite 2009).

Confidence is required as a prerequisite to sharing relevant and sometimes confidential information. A company will show its failures and mistakes in the confidence that the supervisor will give it room to improve its systems.

Confidence is not only a condition for SBS, it is also a product of it. As soon as supervisor and company work together to manage risks, they share interests. This yields even more confidence. This is not surprising if we look at the formula of Benninga, which we presented above. In the SBS process, both parties work on all four aspects of the trust formula.

² We use trust and confidence as synonyms in this paper



COMPETENCIES

SBS demands a number of competencies. The first competency concerns attitude.

Supervision according to the ideas of system based supervision means that the traditional supervisor effectively has to turn switch a button in his/her way of thinking and acting. Inspections, originally a classic output-oriented and distrusting form of supervision, are transformed into audits executed from the starting point that the system is effective and trustworthy. This requires an extension of the set of competencies of both the supervisor and the supervising organization. Open, transparent acting is crucial to reach the desired depth of discussion. The company must be transparent about the business process, and what measures are taken to manage risks and meet regulatory requirements. The supervising authority should be transparent about the observations and the consequences of these observations.

Both the regulated company and the supervisor are expected to act pro-actively. If certain permit conditions cannot be met or are not expected to be effective, the company should react before the supervisor notices a problem. This implies that the pro-active company commits an assessment of the feasibility and suitability of regulatory requirements and communicates any problems with the authorities beforehand. An open communication about what could go wrong and what has been wrong is essential for building trust.

Another competency concerns knowledge about the auditing of risk management systems.

Companies are expected to assure regulatory compliance and risk control in their management systems. They do not need to create a dedicated management system alongside the existing one, but rather integrate compliance and risk control into existing control structures. A management system that is certified according to ISO 14001/9001, EMAS or OHSAS forms a suitable basis.

The public supervisor is expected to really understand the design, purposes and working of these risk management systems as these have to be judged professionally. High-quality training in risk management for senior civil servants was also one of the recommendations of the Better Regulation (2006). This job requires knowledge about management systems in general, and about auditing and communication skills in particular. On top of that, the supervisor should have enough technical and legal knowledge to go into details during an audit whenever necessary. This implies intensive training for those supervisors who have been involved mainly in traditional supervision.

VISION

The most important paradigm that supervisors and regulated companies have to share is that companies are capable of controlling environmental and safety risks and that this capability can be assessed.

Clearly, the management of both the public supervising organization and the regulated company have a crucial role to play in this respect.

The company has to clearly recognize the importance of controlling environmental and safety risks, and act consistently, not only on paper, but also in practice., The commitment of the management is thoroughly challenged during the compliance management audit.

For parties on the government side, from executive to supervisor and permitting officer, there is a need for a clear policy based on the expectation that the regulated company can exert control. Maintaining trust towards participating companies is not always self-evident, especially when things go wrong.

METHODOLOGY

SBS is only possible if there is a suitable methodology to measure the degree to which a regulated company has assured regulatory compliance. The province has found that the current auditing schemes like those based on ISO 14001 are not adequate, partly because the standard is not suitable and partly because the auditing practice is not reliable enough in terms of quality and independence. Therefore, the province has developed its own standard and trained its own people to audit against this standard.

Once audited against this standard, it is found that companies improve their management system significantly, also as regards risk management (Van Dis, 2011). Doing this, confidence further grows and the company deserves more freedom of action.



3. EXPERIENCES

In this chapter we share experiences from the project (Meerman, 2010). Experiences are related to the selection and participation of companies, the learning effect on the management system of regulated companies induced by system based supervision (SBS), the competencies and attitude required for SBS, efficiency and the selection and participation of companies to be involved.

SELECTED COMPANIES

A high percentage (80-85%) of the pre-selected companies participating in information meetings about SBS decided to participate voluntarily in the project. This is perceived as confirmation of the approach aimed at transparency, partnership between public and private parties and practical (non bureaucratic) project management.

It appeared from the first audits that companies participating in the project scored relatively close to compliance competence level three. Almost all companies required a minor effort to reach level three, whereas all the companies needed an improvement in risk management.

The reasons for participation stated by companies were reputation enhancement, government recognition, efficiency and reducing the risk for reputation damage.

PENALTIES

As part of SBS, participating companies are required to measure their own level of regulatory compliance. This, however, can make companies very vulnerable with regard to public prosecution. Penalties issued by law enforcers based on violations detected by companies are counterproductive to the open atmosphere of mutual learning and continuous improvement that parties wish to accomplish. This is called the transparency paradox (Gabriel-Breukers, 2008).

The province has therefore decided to refrain from imposing penalties within its jurisdiction if

- (a) a company takes measures to prevent a violation from occurring by operating an effective compliance management system, and
- (b) the company detects a violation itself, discloses and terminates it and takes measures to prevent this violation from occurring again.

A study into the legal consequences of our method of system based supervision showed there are no pitfalls and that it is within Dutch legal criteria (Van Bellen-Weijnen, 2009).

The province has not yet been able to reach agreement with the public prosecutor on withholding penalties if a company actually measures and improves its regulatory compliance.

ANOTHER WAY

Both the province as law enforcer and the regulated companies participating in the project needed some time to get used to the new approach. It appeared to be important to speak the same language and show interest in mutual problems and positions.

Several blank spots were encountered during the learning-by-doing approach which was chosen. The province has identified challenges for supervisors both in terms of attitude and skills. For individual law enforcers, adopting SBS was nothing less than a culture shock. It is of crucial importance that supervisors carrying out SBS are not focused on finding violations, but concentrate instead on the effectiveness of the management system in terms of risk management. The referential index had to be changed from legal requirements to what is important in terms of risks.

Another blank spot was the lack of auditing skills. The province had to train the supervisors thoroughly to become auditors while maintaining their technical and legal expertise.

The process has benefited from inter-vision and peer review. An inter-vision meeting was organized every three to four months to look at the practical problems and pitfalls the supervisors faced. Teams consisting of two supervisors and one external coach were formed for execution of the audits. By reflecting on the audit reports, the audit team members learned how to interpret findings and formulate conclusions.

Companies and law enforcers do not oppose one each other, but recognize a common interest in managing risks.

Some quotes from participating companies:

"Supervisors focus on risk management and giving positive feedback"

"A new approach in enforcement of environmental regulations"

"Our risk reduces because we look at items we both consider important"

"This will lead to synergy between our different plants"

"Supervisors now really differentiate between companies. Those who are in control are treated differently from those who are not"

"Checking yourself sharpens the consciousness enormously"

"System based supervision helps us to show that we are a good sustainable company"



EFFICIENCY

SBS does not immediately lead to improved efficiency in law enforcement. During the initial period of one to two years, investments have to be made in development of policy, instruments, training and communication. Expectations are that supervision will be improved *and* more efficient after this period of time. Calculations show that efficiency (measured in hours spent by supervisors) can improve by 60-70% for very big plants with equal or even improved effectiveness.

INCENTIVE FOR CORPORATE RISK MANAGEMENT

An important principle of SBS is that the supervisor and regulated company agree on the assumptions and criteria for effective risk management. This removes a traditional objection of companies that public supervision only focuses on compliance to the letter instead of focusing on the risks that regulations seek to reduce. It was already recognized that SBS contributes to a more professional relationship between supervising organization and regulated company (Van Bellen-Weijnen et al., 2010). Several participating companies have indicated that SBS stimulates effective management of risk of environmental damage (Van Dis, 2011, Helderma, 2009, De Bree 2010).

FURTHER DEVELOPMENTS

Having taken its first few steps on a prolonged journey, the province would like to share some of the developments we anticipate in the next couple of years.

We foresee a further integration of public SBS and private management systems like high level structure ISO³. While traditional supervision mainly focuses on different fields of output like emissions of hazardous substances, accident levels, food quality, waste and so on, SBS focuses on the general management system of the regulated company and will thus result into a further integration of public supervision for big and complex companies.

Some companies use control systems that go beyond geographic borders. We have therefore initiated partnerships with other Dutch and foreign public supervisors to form teams. We cooperate with other provinces and have started a European project⁴ to examine the feasibility of international teams of supervisors for multinational industrial companies. This project is expected to yield results in September 2011. This might be a stepping stone towards the internationally organized supervision of multinational companies.

There are still legal challenges in the tension between trust-based form of supervision like SBS on one hand, and the formal penal law on the other hand. We already remarked that penalties can seriously damage trust in the relationship between supervisor and regulated company, whereas that trust is needed to analyze and further improve the level of compliance and risk management.

The concept of the self-controlled company does not only have implications for supervision. It can also have implications for permits and legislation (Parker 2003, De Bree 2006). An essential part of the system based supervision is the assessment of the management of social risks like environmental damage. As soon as it is verified that a company manages its environmental damage risks through SBS, it thus implies that the company has designed and implemented lines of defense to mitigate the risks. These lines of defense are meant to reduce the risk of an undesired event from happening or to reduce the consequences of an undesired event in terms of damage to mankind and the environment. If these lines of defense are implemented and effective, the license does not need to prescribe how risks should be managed. The question how risks are managed is moved from the licensor to the

³ ISO is working on a modular-based management system structure departing from generic processes

⁴ This is the project Compliance assurance through company compliance management systems under the European Union Network for the Implementation and Enforcement of Environmental Law (IMPEL) started January, 2011.

licensee. In this way, the license can become a lot simpler and risk management can become more flexible by leaving it to the professional know-how of the regulated company. A strict precondition is that the company analyses and manages the risks effectively.

SBS is not only suitable for developed countries. When industrial plants are constructed in developing countries, supervision may very well be based upon the principles of SBS, even in the case that no suitable HSE legislation has been issued. Most multinational companies use advanced management systems to control hazards and environmental damage, which can be used as an object for supervision. Because of the competencies needed, however, the public supervisors may need to hire outside expertise to execute the SBS.

4. CONCLUSIONS AND RECOMMENDATIONS

Although hard evidence is still scarce, there are strong indications that system based supervision (SBS) can make supervision more efficient and effective at the same time, if applied with suitable tools on companies with potential for self control. Because SBS is based on trust, it leads to a better relationship between government and regulated companies.

SBS is a supervision method that makes it possible to differentiate between companies with different levels of control. Supervision is a function of the degree to which companies control environmental and safety risks.

On top of that, SBS can help to stimulate regulated companies to improve this control. The working mechanism is that companies are challenged about what they do to manage environmental risks rather than what standards they must meet. By clearly explaining what an effective compliance management system is, companies receive practical feedback leading to improvement on a strategic and operational level.

As SBS affects the management system of the regulated company, it can only be applied in those industries where management systems are used. While these management systems may not be suitable as they are, they can serve as a focal point for optimizing compliance management by SBS. The step-by-step approach of the four-level model makes it possible to improve in feasible stages. Levels three and four require serious effort and physical verification of the compliance management system by the authorities.

SBS clearly requires a different role of the public supervisor than he is used to in traditional supervision. He should be open to co-operation with the regulated company while maintaining his preparedness to intervene when necessary. SBS requires from the supervisor the ability to understand and assess, within a certain given limited amount of time, the level of control within a company's system. This means that his analytical and communicative skills are severely challenged.

For regulated companies, SBS means that the way they are approached by the supervisor depends on their level of internal control. The more pro-actively and professionally they take their social responsibility, the more room they are given to organize things the way they perceive as most effective. This not only results in an adequate supervision style, but can also lead to less-detailed permits.

Developing countries can benefit from the instruments of SBS. If multinational industrial groups realize plants in developing countries, SBS can make use of the internal management systems these companies use. Although these countries may not have detailed legislation, SBS can still be promptly applied at low costs, because it is mainly based on risk management as such. As a result, no specific legislation is required for supervision, except the formal jurisdiction to supervise.

SBS requires a different role of the supervising authority. SBS cannot reduce risks to zero, but then neither can other forms of supervision. If an incident occurs within a participating company in spite of all the controls, the province should not revert to old reflexes, but act as a stable partner and contribute to improvements. As long as the company acts pro-actively and in a responsible way, the supervising authority should be reluctant to intervene. It is especially in these situations that trust should demonstrate its value.



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