

Confidential

NOMINET GOVERNANCE

REVIEW 2008/9

Prof Bob Garratt

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NOMINET: GOVERNANCE REVIEW

By Professor Bob Garratt

1. Context

This Governance Review of Nominet brings together in concise form two recent independent studies:

1. My Board Evaluation Study, followed by my comparison of current Nominet Corporate Governance structure and processes with the 2006 Combined Code of Corporate Governance in response to the DBERR letter; and
2. The Mutuo review - *Nominet - the Way Forward* - which focused more on membership and stakeholder issues.

Both reviews made detailed analyses and recommendations designed to help Nominet have a healthy future in a fast-changing world. Some of the recommendations from the two reviews overlap and so I have attempted here to bring together, in as focused and as brief a way as possible, these analyses and particularly those recommendations and the reasoning behind them. This review contains my personal views and judgements. These are designed to help the membership of Nominet understand and evaluate the key decisions they, not the directors, will need to make soon to ensure that Nominet has a healthy future and, within that, a system of governance which will withstand external scrutiny by the growing number of external stakeholders who have a say over Nominet's future.

My Board Evaluation Study had interviews in December 2008 and was completed by mid-January 2009. The December interviewees included one recently-resigned director. By late January 2009, another director had resigned and a new director had been appointed. These movements on what is a very small Board made my original analysis obsolete. However, the Comparison with the 2006 Combined Code as requested by DBERR and my subsequent recommendations are, I feel, as valid now as in January and given the continuing turbulent circumstances within and without Nominet I have, therefore, focused on this Comparison and the Mutuo study for this integrated Governance Review.

For each Nominet member reading this Governance Review it is my strong advice that they strive to work together to debate and take rapid action on the reforms suggested within it. If not, I believe that external stakeholders will feel obliged to intervene with the possibility that the membership loses that which they have created and valued.

Professor Bob Garratt
London
31 March 2009

2. Overview - and the need for rapid debate and decision making by the Nominet membership

Members' and stakeholders' responses to the Mutuo interviews show that Nominet is highly regarded nationally and internationally for delivering its key purpose – to manage the UK's *.uk* registry. It is seen to have an additional wider and generally-accepted role as a major guardian of the Internet both in the UK and globally. The Mutuo study shows clearly the vast majority of its membership regard its Operational side highly for both its technical expertise and the service levels delivered continuously, and it is seen as a 'beacon' organisation in the UK Internet industry.

Yet, despite this favourable image externally and internally, recent events, especially around the composition and processes of both the membership, its voting processes, and the roles and processes of the Board of directors, have raised serious questions in members' and powerful external stakeholders' minds over how, indeed whether, the Nominet membership can move forward constructively to design a future for Nominet and thus resolve the continuing public display of dissension that is unsettling both members and stakeholders currently.

The Fundamental Problem

A simple way of stating my observation is that, whilst the world has moved on, neither Nominet's membership structure, nor its constitution, has kept up with these external changes. Therefore, both its membership composition, voting processes and governance system are now in need of major reconsideration and rebalancing to cope with its changed external environment. I feel it important to stress that only the membership can resolve these issues, not the Board of Directors who ultimately are agents of the member/owners. Given the dynamics of the external environment, the members seem to have just one chance to rethink and use the luxury of their self-regulation to escape from their present problems. Failure to self-regulate in these areas could bring with it the threat of public intervention in Nominet's affairs and the imposition of external regulation. The choice is the membership's. And they need to agree soon a process for involving the full membership in this crucial debate.

The Fundamental Questions

For that debate I am suggesting reconsideration by the membership of three crucial questions:

1. What does being a member of Nominet mean in this changing world?
2. What are Nominet's obligations to the wider range of stakeholders who are now affected by, or have potential or actual regulatory powers over, its actions?
3. What do the answers to these questions mean to redesigning the governance system of Nominet?

I argue that, for Nominet to continue as a legal entity in its present not-for-profit form, it is essential for the membership as a whole to focus its energies away from their recent publicly-aired micro-politics and to face up to their relationship with the major changes in its environment which are already shaping Nominet's future

regardless of whether or not the membership is aware of these trends. Amongst these are:

- the national reliance on the Internet as the major communications system for all types of organisations and for individuals;
- the consequent diversity of, and sometimes contradictory, interests within this wider, national Internet community which includes registrants, general public/end-users, and Government as well as the Nominet staff;
- the Credit Crunch and its consequent tightening of national and international financial controls, including the proposed tighter regulation of those setting prices within the national economy;
- significant shifts in thinking and tougher regulation in global corporate governance practice and risk management;
- the fast-changing face of Corporate Governance in the UK in which Nominet must show legal compliance, especially the 2006 Companies Act and its *Seven Non-Exhaustive Director's Duties*.
Even in recent days the strong statements from the Financial Services Authority and the Financial Reporting Council show that the regulatory future will be much tougher than before and that any group with potentially monopolistic power may be challenged.
- The DBERR letter and its role as a warning signal that the Government on behalf of the general public is concerned over the current behaviour and roles of the Nominet membership.

There are more, but I rate these as the most important, both from my perspective as someone working in the world of national and international corporate governance, and from the responses to the Mutuo Review from the majority of Nominet members which say that changes are needed to their current governance model. They see this as freeing the growth and development of Nominet and allowing the chance to grasp better such opportunities as ENUMs.

The Need for Nominet Membership Debate and Decision Making

I argue that Nominet needs to involve and develop better its membership to ensure that its rate of learning is equal to, or greater than, the rate of change in its external environment – a cybernetic view of organisations made manifest in *The Learning Organisation* concept. This, in turn, will allow Nominet to be seen as more valuable, and less self-interested and self-absorbed, by the stakeholder community which will ultimately determine its continuity. Nominet is now too important within the national infrastructure to be left to its own self-regulatory devices without some form of external oversight and supervision.

As an outsider, I pose the question as to whether the Nominet membership have the political will to change themselves to cope with this changed environment? Or will outside intervention become necessary to protect the wider national interests? If so, Nominet could still carry on as a membership-based organisation but without many of its current powers especially in the areas of self-regulation and tariff setting. Is this what the Nominet membership wants?

3. Nominet Membership Issues

Nominet may have started with high altruistic, not-for-profit values consciously apart from the business world but, over the last decade, the Internet has become highly commercial and the increasingly financial interests of some of its most powerful members seem to be driving Nominet towards a non-altruistic path. Is this the wish of the majority of its membership? The Mutuo evidence shows that this is clearly not the case.

This growing concern about the varied motivation of the membership is compounded by the decision taken early on in Nominet's life that it would give a fee discount for those registering for *.uk* who opted to become a member. This had the effect of increasing numbers and cashflow initially but it built in an unforeseen long-term problem – it created a majority of passive members whose main interest was the discount rather than any form of truly participative membership. A largely passive membership is a problem with any membership-based organisation but it is now particularly noticeable in Nominet's case and has led to two further issues.

Of Voting Deficits, Stakeholders and Potential Cartels

First, that a minority of members have secured for themselves a powerful position in the organisation which is reinforced by a constitutionally-backed barrier to change – the 75% (and even 90% in some cases) voting hurdle. With a mainly passive membership, this is a very high hurdle to clear and so means that the minority which does vote has effectively permanent control unless the requisite majority can be motivated to vote on an issue. This raises two further issues in my mind:

- Does the design of the current Nominet constitution now ensure a permanent deficit for its ordinary members? Are they disenfranchised effectively? With the two-tier voting system it could be interpreted that way. Is this what the wider membership want? Not according to the Mutuo study.
- And are they willing to reduce the percentage of the vote to lower the hurdles to ensure a more participative and responsive membership? This needs debate and testing but seemingly, from the Mutuo study, the answer is, yes. If faced with the wider public exposure of this voting system, will this be a negative factor in swinging the public and Government against Nominet as currently constituted?

Second, and following on from the voting issue, has the Nominet membership drifted into a situation where its economic activity can be seen to be potentially against the public interest? I am not an expert in this area. But two issues, Nominet membership and registration charges, have coincided and caused many members confusion. If the membership voted on only the membership fee that is one thing. Yet when national registration charges are decided only by the Nominet membership there must be a case for wider public concern. Curiously, under the Nominet constitution, the Board of Directors has no power to intervene here. But where is the public interest represented? How do other stakeholders have their say? Is there now a case for, for example, the Office For Fair Trading investigating? Or the Monopolies Commission? And, ultimately, could a group of members getting together without any public oversight be viewed as a potential

cartel? It is reported in the Mutuo study that the original design of Nominet's constitution was to protect its members from each other. But now Nominet needs to face up maturely to its duties to the wider public interest.

It seems to me that the Nominet membership need to come together to consider urgently their responses to such questions before that wider world takes action into its own hands. Knowing a little about Governmental processes, I take the DBERR letter as a very serious warning that Nominet is under observation as a possibly dysfunctionally-governed national organisation. This is a paradox as the excellence of its Operations is acknowledged simultaneously. I stress that resolution here cannot be delivered by the Board of Directors.

This is specifically a membership issue as they are the owners of the organisation. It is only after the members have agreed their responses that the Board and the executives can take effective actions on these issues.

Such membership decisions will need to be taken rapidly as the external environment may well change even faster. It is public knowledge that new legislation is under consideration which will apply to the communications industry. It does not take a genius to realise that this gives the Government an ideal opportunity to change Nominet's role and composition quickly and with likely public backing.

4. Towards Possible Constitutional Change

Members may well feel that I am exceeding my brief here. But given the unique and privileged insight into Nominet that I have been given through my own and the Mutuo studies, I should like to help the membership secure a healthy future for Nominet rather than just deliver a report and disappear. So I am writing these words in the hope that they will enable the membership to be able to find its own salvation without the need of further external intervention.

I have compared the richness of the findings from the Mutuo and my own studies and tried to distil these here into a range of crucial questions for the Nominet membership. All of these will need addressing simultaneously by the membership. They are in three broad and overlapping areas:

- Those actions needed to protect Nominet and keep it safe in the changing external world;
- Those actions needed to ensure Nominet continues as a compliant legal entity over the period ahead;
- Those actions needed to ensure that Nominet has a long-term future nationally and internationally.

I shall go even further in my presumption and suggest that ways must be found of reaching the whole membership, and key stakeholders too, by conducting an urgent and rolling dialogue and consultation and to reach conclusions in all three areas as soon as possible. This dialogue and consultation should lead to a major General Meeting - which would have the character of a Constitutional Conference - where the revisions, having been debated, are voted upon and agreed. Nominet members will know much better than I how to handle the Internet debate and any voting processes. However, I shall make the case strongly for the importance of

face-to-face meetings at the regional and national levels as well if a critical mass is to be built to get over the 75% voting hurdle on each issue.

Two related groups of issues stand out:

First, to protect Nominet in the immediate future by the granting of the full normal range of regular powers to the Board of Directors. This is based on my observation that the current Board is hobbled constitutionally so that it cannot fulfil its proper range of functions as a Board of Directors. This proposition reflects the existing external concerns over the effective governance of Nominet as made manifest in the range and type of questions asked in the DBERR letter. It does not remove the right of members to select and remove their Board but it does give the Board the powers to allow them to fulfil their proper role when they are in office.

Second, equally urgent and needed to underpin development into the long-term, are a series of Policy questions for the Nominet membership:

- What is the Purpose of Nominet?
- What are the Vision and Values of Nominet?
- Do we want to continue as a not-for-profit organisation?
- Do we want to reform the voting procedures to allow all members to feel enfranchised?
- What is the Development Strategy of Nominet?

5. Of Corporate Governance Compliance and Development

Following the DBERR letter of 15 October 2008, I was asked by Nominet to compare its corporate governance structure and practices with the 2006 Combined Code of Corporate Governance issued by the Financial Reporting Council. This has been completed in detail in a separate review. What follows below are the recommendations I make on the revamping of the Nominet Board structurally and procedurally to allow better compliance and more effective direction giving, strategic thinking and prudent control. I maintain that the current Nominet Board of Directors is constrained by Nominet's constitution where it cannot fulfil its corporate governance functions – to drive Nominet forward and to keep it under prudent control – in line with current legal and practice demands. Although much of the current Nominet membership debate about governance has been on the behaviours of the personalities involved I am arguing here that, regardless of the individuals involved, the present governance issues would still arise due to the structural flaws caused by the drafting of the constitution. These flaws need rectifying regardless of who becomes a member of the Board.

It should be noted that the 2006 Code is designed for companies listed in London, i.e. large corporations quoted on the stock exchanges. Nominet is not a company limited by share capital but a company limited by guarantee. It has no shares. It can create a surplus but this surplus must be used to pursue its objectives stated in its constitution. It cannot distribute any surplus to its members. This was the conscious and altruistic design of the founder members and it defines Nominet as a legal entity.

So why worry about a Code with which Nominet is not obliged to comply? The 2006 Code has become to a great extent the model code for many non-listed businesses and, in mildly modified form, can be seen in action in NHS Foundation Trusts, housing associations, not-for-profits, and Government agencies in the UK and many overseas legislatures. My detailed comments regarding Nominet and the Code are made in my separate review of January 2009 *Comparisons With The 2006 Combined Code*.

Here I have listed my suggestions to the membership for modifications to the Nominet existing constitution to bring it into line with current good practice in corporate governance and especially with the 2006 Combined Code with which DBERR has asked for comparison. I argue that, if the membership do not bring their present corporate governance system into line with good practice, this will give another negative signal to the wider stakeholders and this will in turn bring Nominet under even more public, especially governmental, scrutiny and potentially more negative publicity.

Rebalancing The Board So That It Can Exercise Its Normal Powers

To help prevent this I am suggesting ways of *rebalancing* the Board of Directors so that it can perform better its primary tasks of balancing both driving Nominet forward and keeping it under prudent control.

- a) **To split the present Chairman and Managing Director role**
Currently this combined role is built into Nominet's constitution. However, having a combined role is considered bad practice in modern corporate governance circles as it concentrates too much power into one pair of hands at the head of a business. Indeed, the splitting of these roles has been mandatory for listed companies since 1992. I note that the present Chairman, who in other companies has worked under the 2006 Code, has tried hard to play only the Chairman role. Yet this is not what Nominet's constitution demands. It seems very unwise that Nominet continues what is seen as bad practice here. It reflects badly on Nominet as it does not allow for either role to be developed fully nor for effective Board oversight of each role.
- b) **To create a separate role of Managing Director who is a full Board member**
Again, this is good corporate governance practice and mandatory under the 2006 Combined Code. If the Chairman is 'the boss of the Board of Nominet' then the Managing Director is 'the boss of the day-to-day operations of Nominet' and is held fully accountable for them. This suggestion would require that the Managing Director becomes a statutory Board member, and that the current role of Chief Executive is absorbed into the MD role.
- c) **To revise Nominet's system of voting for directors so that it is compliant with both the words and spirit of the UK's 2006 Companies Act and the Combined Code in relation to conflicts of interest**
This is designed to clarify the present position in Nominet where a conflict can be acknowledged but the Board has currently no power to do anything about it. I am suggesting, for example, the keeping of a register of interests of Board members, the updating of these at each Board meeting and having a clear process for deciding if a conflicted Board member may speak to a

topic, whether they can vote on a specific issue, and that these decisions are recorded in the Board minutes.

d) The Board to have the power to appoint at least two experienced and independent NEDs to the Board in addition to the present NED composition

There are four reasons for making this proposal:

First, to add wider diversity to the industry-specific experience of Directors elected from the membership. This is always an issue in membership-based organisations as many elected Directors do not have any previous directoral experience.

Second, to allow Nominet to be seen to be acknowledging their wider role in creating the ‘public good’ by bringing in some externally-orientated Directors with their critical, independent oversight to balance the Board’s risk assessment and decision making processes.

Third, to give the Board flexibility in bringing specific functional experience onto it where there is an obvious need.

Fourth, to allow the appointment of a Senior Independent Director who can act as a point of contact for members wishing to discuss issues such as the performance of the Chairman.

I suggest that good practice for these independent NEDs is that they are part of the Board’s annual evaluation, and that they have a maximum term of three three-year contracts subject to satisfactory performance.

e) To ensure that the Board has on it three Executives who are also statutory Directors

This is a further step in achieving better balance on the Board by having the Managing Director and other supporting roles as Board members as part of their employment contract. This would allow broader regular Board oversight mechanisms of the business and the development of Nominet.

f) To appoint a professionally-trained Company Secretary as an Officer of the Board

This role has proved crucial in many Boards, especially those onto which many members may be appointed without previous directoral experience. The Company Secretary is expected to ensure good practice and legal compliance around the boardroom table and to act as ‘the conscience of the Board’ when necessary.

g) To create a clear job description for each director

This is to go beyond the existing job description that is contained currently within the call for members’ nominations to the Board. It needs to state their corporate legal duties and responsibilities, time commitments and the personal liabilities to which they will be committed. Such job descriptions must apply equally to the Chairman, the Managing Director and any other executives who are statutory directors.

- h) To create annual evaluation and development plans for the Board itself, each committee and each individual director**
 This is standard practice and is contained in, for example, the Combined Code, the NHS Monitor Code, and, please note DBERR's *Building Better Boards* recommendations. They, and others, advocate using the *Learning Board Model* in which I declare an interest (see Appendix 1).
- i) To ensure that the Board nomination, selection, induction, competence building, evaluation, renewal and de-selection processes are reviewed regularly**
 This can be started immediately without the need for constitutional change.
- j) To publish in the Annual Report the reasons for, and cost of, the legal fees for directors seeking independent advice concerning their directoral roles**
 This is to make these costs transparent and, given the recent experiences, to demonstrate the future effectiveness of the induction and competence building processes. Hopefully, it will reduce the tendency to litigation amongst future directors.
- k) To review and publish the remit and membership criteria of the Audit, Remuneration and Nominations Committees.**
 In March 2009, I realise that a start has been made on the Audit Committee. In many businesses it has been found wise to combine the Nominations and Remuneration Committees.
- l) To reconsider the role and processes of the Policy Advisory Body so that it becomes more an 'outward facing' part of the membership's connection and sensitivity to the external stakeholders and the public good.**

But none of these is worth worrying about for too long unless the membership face up to the changed and changing external environment, and their consequent need to adjust their role and their constitution to cope with this.

I argue strongly that these *corporate* governance revisions to ensure compliance with good practice externally are needed now, and before the constitutional developments proposed below.

6. Further Constitutional Development Recommendations

So I come back to my three original questions for the membership:

1. What does being a member of Nominet mean in this changed world?
2. What are Nominet's obligations to the wider range of stakeholders who are now affected by, or have potential or actual regulatory powers, over, its actions?
3. What do the answers to these questions mean to redesigning the governance system of Nominet?

In addressing these questions, the membership should consider thoroughly and urgently the following recommendations which flow from the research and analysis carried out by Mutuo:

Recommendation 1: Nominet's Purpose:

Clarify and Confirm Nominet's Purpose as Public rather than Private and:

- Express it clearly as a commitment in the constitution.
- Consider whether a company limited by guarantee is appropriate for the purpose.

Recommendation 2: Commercial Discount Arrangements:

- Detach the commercial discount arrangements on multiple registrations from membership to remove any financial barriers to wider membership. Give final responsibility to the Board for determining charges for registration and membership.

Recommendation 3: Broaden Membership

- Introduce constituencies for membership, comprising at least (1) users and (2) staff.
- Consider establishing further constituencies within users, e.g. (1) individual/personal; (2) commercial; (3) education; (4) voluntary and charitable; (5) public sector.
- Whatever representative arrangements are introduced, introduce constitutional requirements for review on a regular basis to ensure that they reflect what is appropriate as use of the Internet develops.
- Revise voting arrangements to achieve a fair balance across the membership.
- Develop a membership strategy for the recruitment and development of active engaged members, and resource member development.

Recommendation 4: Revise current membership and ownership structure.

Consider how to:

- Achieve governance competence and representativeness.
- Achieve a balance of interests between relevant constituencies of members/stakeholders.

Look at five potential models for achieving this:

- Adopt the Garratt proposals within this Review for the development of a full Unitary Board structure.
- Use a Foundation Trust model (like Homerton NHS Foundation Trust), with a professional Board of executives and non-executives (one of whom is chairman), and separate representative body including elected members and stakeholder representatives 'The Board of Governors' (if appropriate).
- Use a Co-operative model (like Co-operative Group) with elected Board (one of whom is chairman), and delegation of responsibility for running the day to day business to executive team (who are not Board members) so the focus is on professional non-executives.
- Use a Community Benefit model (like Salford Community Leisure) with representative Board, which could include stakeholders and professional non-executives (one of whom might be chairman), and responsibility for running the business delegated to executives.
- Consider composition and balance of representative elements, to ensure inclusion of appropriate representation from relevant interest groups amongst interested persons – i.e. different constituencies of members, representatives from key stakeholders or other representative bodies.

Whatever arrangements are arrived at, introduce constitutional requirements for review from time to time to ensure that those arrangements continue to be appropriate as use of the internet develops.

Recommendation 5: Entrenched Provisions

Revise majority required for changing the constitution to more normal arrangements, but include more appropriate and effective arrangements for entrenching provisions which should not be changed (this will depend on which corporate form is used).

7. Nominet and the Future

Taken overall, my fundamental recommendation for Nominet and its membership is that it should engage in an urgent, positive and thoroughgoing dialogue on all the constitutional and corporate governance issues which I have set out earlier, with a view to making appropriate changes as soon as reasonably can be made.

The Nominet membership must be willing to:

- a) positively address the more fundamental questions about its membership and constitutional structure;
- b) make the changes necessary to modernise and strengthen its corporate governance through granting normal powers to its Board of Directors.

If it does so, it will help Nominet's interface and relationships with its growing range of stakeholders and so help its 'horizon scanning' and its subsequent formulation of policy in relation to, for example:

- the political environment
- the physical environment
- the economic environment
- the social environment
- the technological environment
- the global trade environment

This would help Nominet deliver more effectively to its stakeholders its 'triple bottom line' of financial, environmental and social responsibility.

Just as importantly, it will help secure the continued self-regulation of the *.uk* domain name, with all that means in terms of Nominet's greater potential for innovation and creativity, and so will help secure the altruistic legacy of Nominet's founders for both the present and into the future.

Professor Bob Garratt
31 March 2009

