# The Co-operative Group

# Report of the Independent Governance Review

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Paul Myners

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# DISCLAIMER

The Report has been prepared by Lord Myners who was commissioned by the Board of Co-operative Group Limited (the "Group Board") to conduct a comprehensive independent review of the governance of Co-operative Group Limited (the "Group").

The Review's Terms of Reference are set out in Appendix 1 of the Report.

The views, findings and recommendations included in this Report are entirely those of Lord Myners and are based on an assessment of the information provided by the Group, the Group Board and others in response to requests for information and during the course of interviews.

The Review has not conducted a forensic investigation or an audit of the information made available to it. The Review generally assumed the veracity of information provided. No representation or warranty is provided as to the accuracy of such information. Public information and industry and statistical data are from sources that have been assumed to be accurate without verification. No representation as to the accuracy or completeness of such information is given.

Other individuals considering the same information could form a different conclusion. Similarly, the Review might have formed a different assessment had it considered other information. Accordingly, the findings of the Review should not be treated or relied upon as determinative of any fact, nor of the performance of, or compliance with, any legal or regulatory obligation, responsibility or function by any party.

The Report is not for the purpose of guiding or influencing the conduct or decisions of any person other than the Group and its members, including any investment or other financial decisions or the decisions of any regulatory or government body. Accordingly, it must not be relied upon for that purpose by any party. In this respect and generally, the Review accepts no legal responsibility or liability for the contents of, or any omissions from, the Report or any actions taken or decisions made by any party as a consequence of the views, findings and proposals set forth in the Report.

Any references to or comments on regulatory requirements, standards, or guidance reflect the view of the Review only and should not be relied on for any purpose. No responsibility is taken for changes in market conditions or laws or regulations and no obligation is assumed to revise this Report to reflect changes, events or conditions, which occur subsequent to the date of this Report.

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# Foreword

When I was a child growing up in Truro, Cornwall, my mother told me that I should always try to spend my pocket money in the Co-op in Kenwyn Street. I asked her why. She told me "Because they are different from the other shops. We own the Co-op. It's for people like us." I found this difficult to comprehend given our straitened circumstances, but I have never forgotten the message.

I am a strong believer in co-operative ownership, the benefits it can deliver to individuals, the broader community activities it can support and the social goals for which it stands. I fully recognise the enormous strengths of the co-operative movement around the world. Co-operatives are a significant part of the global economy.

That is why I care deeply about the future prospects for The Co-operative Group. My aim in carrying out this Review of the Group's governance has been to develop recommendations that will strengthen its ability to recover from the traumatic shocks it has suffered over the last year and help position it for renewed success.

The co-operative ownership model can – and often does – deliver powerful economic advantages. But its superiority over other forms of ownership is not inevitable and guaranteed. For a consumer co-operative, such as the Group, its advantages have to be earned, day by day, through delivering outstanding service and value for money to customers who, especially in food retailing, have plenty of choice where to spend their money.

The implication for the Co-operative Group is straightforward. It needs to have a compelling strategy supported by tightly disciplined financial management. The catastrophic losses that have arisen over recent years are the direct result of a failure to put these in place. I want to stress the importance of financial management because every member should understand its significance. The Group, like other co-operatives, depends for its equity on the surpluses that it earns from its operations each year. It is these retained earnings that it needs for investment in future growth but also for the repayment of the massive debt that it has run up in recent years. It is only after these priorities are safely assured that it can consider dividends to members and a larger allocation to its social goals. The Group cannot raise equity from the capital markets. There is no short cut to recovery from its present weakened state. It will require retrenchment and some painful choices. After 150 years of development, and an extended period of financial decline, the organisation has seen more than half of its net assets wiped out in the past five years. Financial health can only be restored through steady, step by step, rebuilding of the Group's profitability and repayment of its excessive debt.

I have felt the need to set this all out in stark terms because it is directly relevant to this Governance Review. All of the issues I have described above are primary responsibilities of the Group Board. It is the directors who are accountable to the entire membership for discharging their responsibilities with proper care, with skill and with serious effort. Their competence in providing constructive challenge, guidance and support to the Executive team is the essential foundation for future success. But such competence has been sorely lacking. Indeed, as yet no director has felt obliged to speak up for their own contribution to failure.

It should hardly need stating that all of these issues are also of the utmost importance to the Group's 90,000 employees and its pension scheme members. That is why governance, while it may seem just a technical subject is, in reality, a matter of high significance.

This is the context for the recommendations I set out in the following pages. My task has been to develop a set of practical reforms that will protect the Group from the deplorable governance failures that have been exposed over the last year. The proposals that I am putting forward involve radical change to current practices. But it is these current practices that have led directly to the near-collapse of the Group.

I want to assure all members that the reforms I have set out are fully compatible with the core values and principles of co-operative ownership. I have no interest in advocating the adoption of a plc model, as some of my critics have claimed. But I do want to see a governance structure that works; the present one has lamentably failed.

The details of my proposed reforms are set out fully in the Review. I would just like to highlight three particular features. The first is the need to put in place a Group Board that possesses the skills and experience, as well as the commitment to co-operative values, that will enable it to match in quality the boards of its primary competitors. The second is the creation of a new National Membership Council, to provide a powerful representative forum of elected members for holding the Group Board and Executive to account, and for acting as the guardian of co-operative values. The third core element of my proposed reforms is the extension of full membership rights to all Individual Members, consistent with the fundamental co-operative principle of 'one member, one vote' and substantially increasing the scope for genuine participatory democracy.

Some people may have expected me to water down my proposed reforms. They may have felt that my Interim Report was no more than an opening shot. That could not be farther from the truth. I committed to giving the membership a full diagnosis and the best possible objective and independent advice, much as a doctor would diagnose a patient. It would be completely irresponsible to change my diagnosis because the prescription is unpalatable, and hard for some elected members to accept. I would then no longer be prescribing the best solution for the organisation.

I am well aware that my proposals face intense resistance. As this Review has proceeded, I have taken the opportunity to look at the outcome of earlier reform initiatives, notably the Co-operative Independent Commission of 1958, chaired by Hugh Gaitskell and largely written by Anthony Crosland. This was a comprehensive, penetrating account of the challenges faced by the Movement as it tried to respond to the competitive threats of the multiple retailers. Yet despite the accuracy of the diagnosis, and despite Gaitskell's plea, "*Don't defer, and defer and defer*", its proposals were largely kicked into touch.

Why was the Movement so resistant to change at that time, and what accounts for the present degree of resistance, given that on each occasion the evidence of failure has been stark?

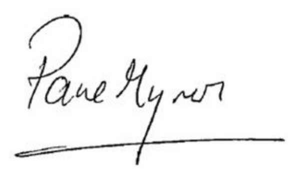
Two explanations are apparent. The first is that co-operative ownership, when it reaches the scale and complexity of the current Group, creates deep tensions. There is tension in determining the appropriate boundary between democracy and professionalism; there is tension between local or regional autonomy and central direction; and there is tension in resolving the respective interests of activist members and 'shopping members'.

For good reason, resolving these tensions is not easy. Nevertheless, that is what I have sought to achieve in this Review.

The second explanation is more disturbing. It is that the resistance of traditionalists owes much to the culture of entitlement that has grown up within a very small but highly active proportion of the membership. This has undoubtedly created strong vested interests and a reluctance to rethink existing ways of doing things. In this Review I draw attention to the harmful effect this has had on the culture of governance within the Group. In particular, I have myself witnessed repeated instances where there has been denial of responsibility, corrosive suspicion, deliberate delay and a practice of hiding behind "values" in order to deflect or stifle criticism and protect self-interest. It was the combination of these factors, when discussing the approval of this year's accounts, that obliged me to resign as a director of the Group after only four months.

Despite the current difficulties it faces, and even if the road to recovery is long and hard, the Group retains the potential to emerge once again as a thriving example of co-operation. While I deeply regret the departure of former chief executive, Euan Sutherland, who did so much to rescue the Group last year, he had already assembled a strong Executive team and had begun to map out some highly innovative strategies for reconnecting with members and transforming the Group's effectiveness. I know that the current Executive is pressing ahead fast with this work, under Richard Pennycook's able leadership. My hope is that as this vision for the future emerges it will once again inspire members, customers and colleagues. The prize is clear: a transformed organisation with a compelling mission that meets the needs of today and tomorrow; a purpose-led organisation defined by the power of reciprocity and mutual advantage; and a refreshed appeal to members, championing the interests of local communities.

I have no doubt that the Co-operative Group can over the next five years reverse a decline that started over fifty years ago. But I am less confident that it will choose to do so. Much will depend on the small number of "elected democrats", less than 1 in 10,000 of the Group's entire membership. Will they put their self-interest to one side for the greater good, acknowledging the collective failure of the current Board and the crippling deficiencies of the entire governance system? Much will depend on what happens in Manchester at the Annual General Meeting and Special General Meeting on Saturday, 17th May. I have no way of reaching an informed view on the likely outcome of the vote but in the event that the vote passes I will be focusing closely on the expressed appetite for reform, and the messages sent to the Board about the necessary pace of change. In recent months I have had many meetings with members at all levels within the Group's elected hierarchy. I would say that the Group Board and many on the Regional Boards are still stuck in denial over this near ruinous failure of governance, whereas the vast majority of ordinary members feel justified anger. Radical decisions on governance structure need to be taken very soon – and with resolution – if the Co-op, as my mother knew it, is to be saved. The decision lies in the hands of the elected democrats. I have done all I can do.



**Paul Myners**

# Introduction

## Purpose of the Review

In December last year, I was invited to join the Group Board and to conduct an independent Review of the Group's governance. As I said when I was appointed, my work is intended to be forward-looking and to provide the Group with a robust governance framework to replace the current flawed system. In particular, the massive losses caused by the near collapse of its banking subsidiary had brought the entire organisation to the brink of failure. This dramatically highlighted the need for the most rigorous examination of the Group's governance.

Under its Terms of Reference (set out in full in Appendix 1), the primary emphasis of this Review is on the effectiveness of the Group Board and ensuring that it properly serves the interests of the entire membership. With that aim in mind, I originally set out to undertake the Review in two phases with an initial concentration on radical reform of the Board where the need for urgent remedial action was self-evident. My intention was to present this to the Group's Annual General Meeting in May. A second phase was then intended to focus on the governance options for strengthening connectivity with members.

What quickly became clear in my investigation was the extent to which any set of recommendations for reform of the Board needed to be integrated with proposals for reform of the entire electoral system through which member control has been exercised. It was not only the Board itself, but the electoral pipeline supplying incoming Board directors that needed urgent attention. I have therefore found it necessary to develop a far more comprehensive set of recommendations at this stage than originally anticipated. These now encompass the full scope of my original remit and cover the entire governance framework of the Group. Throughout this work, I have remained committed to finding governance solutions that fully respect the essence of the Group's co-operative ownership model, and the loyalty and commitment which its values have inspired among members.

The content of this Review builds on the Interim Report that I published on 14th March 2014 in the immediate aftermath of the resignation of Euan Sutherland as chief executive. This had suddenly placed the Group's governance under further intensive scrutiny. At the request of the Group Chair, Ursula Lidbetter, I therefore undertook to provide – within a few days – a progress update on the Review's main conclusions and recommendations. What the present Review sets out is correspondingly a far more extensive body of relevant facts and analysis than I was in a position to share at that time. My aim throughout this work has been to ensure that the proposals emerging from my Review should be securely founded on a strong base of evidence.

The recommendations set out in this Review are closely in line with those proposed in my Interim Report. They are however far more detailed. In particular, I am now able to explain in much more depth and with more precision how certain critical elements of the proposed governance structure will work. In that connection, I would particularly draw attention to the discussion, in Chapter 5, of the proposed National Membership Council. This is a governance innovation that has the potential to provide elected members with a powerful forum for engagement with the Group Board and the Executive.

Similarly, also in Chapter 5, I would emphasise the importance of the arrangements I am proposing for the Nominations Committee of the Group Board. This is the body that will be charged with identifying suitable candidates for board approval and ultimately for election or re-election by members. Both this and the NMC are crucial components of the governance framework that I know members have on their mind. Both of them, if they are to function effectively, will depend on a wholehearted willingness, on the part of elected members, to give them a chance to work. This will require greater mutual trust and a greater spirit of genuine co-operation within the governance structure than currently exists. I hope this will be forthcoming, because this is the pre-requisite for restoring the Group's fortunes.

As a final comment on the structure of this Report, I would like to draw attention not only to the main body of my findings and recommendations which are briefly outlined in the overview below. I have also included a number of substantial appendices that contain important additional evidence and insights on different aspects of the Group's governance. Among these, I have included a lengthy section on "frequently asked questions" which is intended to provide answers, in straightforward language, to a number of the questions that members may understandably have on their minds. In keeping with my intention, throughout this exercise, to explore new ways to connect with the membership as a whole, it is also my intention to respond to further questions from members in a webinar session to be held shortly after the publication of this Report.

## Acknowledgments

This Review has been a challenging exercise to undertake. I would like to thank the many individuals from within the Co-operative Group who have contributed to it. This also includes ordinary members and elected members at different levels within the electoral hierarchy. I am similarly grateful to all those members who submitted responses to the Review's website. While fully respecting the independence of this Review, the Group Executive has also provided unstinting support to my work. I very much appreciate the input that the Review received from many other individuals, academics, trade unions and other organisations from within the Co-operative Movement and beyond, all concerned for the future of the Group. It was particularly helpful to hear the perspectives of two former chief executives, Sir Graham Melmoth and Martin Beaumont.

I would like to express my most sincere appreciation to the team that has worked with me on this Review. The team was ably led by Paul Coombes, Chair of the Governance Centre at London Business School and, in my humble opinion one of the foremost thinkers on corporate governance in the UK. Further valuable insights and leadership were provided by Simon Wong, a governance adviser with affiliations to London School of Economics and Northwestern University, Chicago. Liz Mohr, an experienced Board adviser, brought insights based on practical experience and provided valuable counsel. They all acted in a personal capacity. They brought a critical and objective eye to their work and displayed great energy and tolerance. I was also helped by legal advice from Allen & Overy, one of whose associates, Willoughby Knight, was seconded to the Review. Finally, Tracy Vegro, a Senior Civil Servant on loan to the Co-operative Group from The Cabinet Office, provided a highly effective liaison role for the team with the Group. This Report owes more to them than to me.

## Conduct of the Review

Over the past four months, the Review team has engaged in an intensive effort to analyse the nature and causes of the Group's governance dysfunctions, explore potential solutions to remedy them and devise recommendations to ensure that the Group's governance is fit for its scale and complexity.

The activities of the Review team have included the following:

- Meetings with Group Board directors, independent professional non-executive directors ("IPNEDs") on the Subsidiary Boards, executives and staff, individuals directing or managing co-operatives in the UK, professional advisers, interested stakeholders and academics specialising in co-operatives

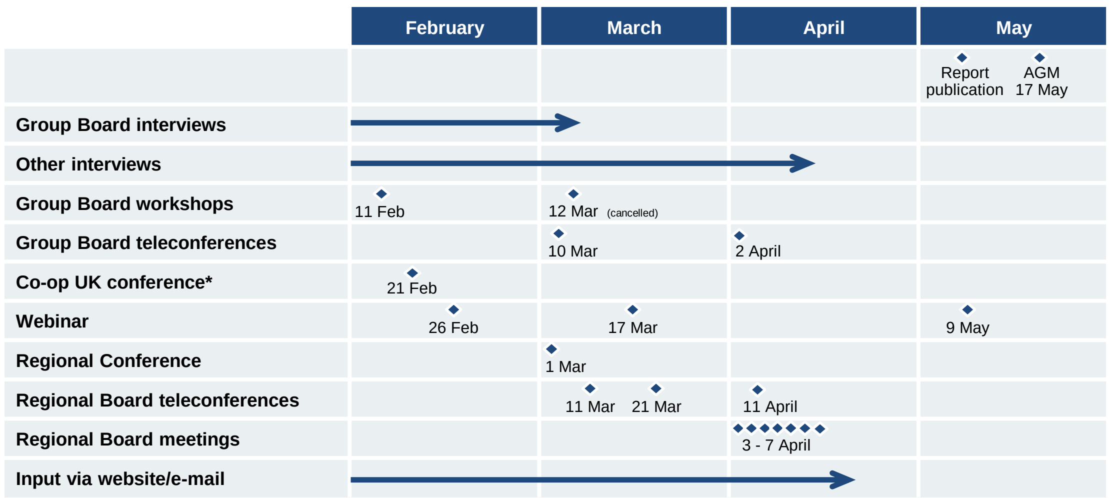
- Reviewing a wide array of the Co-operative Group's ("TCG") internal documents, including a full review of the Rules and secondary regulations that underlie the current constitution and materials on past Constitutional Reviews to understand why previous efforts failed to achieve fundamental changes to a governance architecture long known for its labyrinthine complexity

- Researching mutual forms of ownership in several sectors to understand better why certain ones have succeeded while others have failed. The Review team has also looked into the governance arrangements at other leading co-operative and mutual organisations in the UK and abroad

- Researching the skills and experience of non-executive directors at the boards of the Group's primary competitors

- Engaging with the membership through specially convened conferences for Regional Board and Independent Society Members, Regional Board meetings in all seven Regions, a series of webinars and submissions to the Review website

**Exhibit 1 – Independent Governance Review engagement activities**




* For independent societies

## *Overview of the Report*

Chapter 1 provides a summary of the Review's main findings and recommendations.

Chapter 2 examines the current governance framework. It analyses the structure, composition, and responsibilities of the Group Board, Regional Boards and Area Committees. It examines the current electoral processes and also the available data on the Group's membership base. It reviews the rights accorded to ordinary members, which are exceptionally weak for an organisation that proclaims its democratic credentials and, moreover, are not in line with the Group's stated principles. Lastly, it examines governance features that have contributed to the entrenchment of incumbent elected members and the weakening of democratic co-operative principles.

Chapter 3 analyses the reasons underlying the complex three-tier governance structure that the Group has had in place since 2001. In particular, it discusses the extensive powers held by the Regional Boards and the adverse consequences for the effectiveness of the Group Board. The

Review then describes the context for the two major attempts since the 1950s to strengthen the overall governance of the Co-operative Movement, and the failure of these initiatives to secure fundamental reform, at least with regard to the effective governance of the Group. It also discusses how retail consumer co-operatives in the rest of Europe have responded to similar competitive pressures.

Chapter 4 analyses the weaknesses of the Group's governance model, in particular a manifestly dysfunctional Group Board, a discredited electoral system that has irreparably weakened the governance system's legitimacy and a disempowered and neglected membership. This chapter also explains why an effective board is particularly critical for co-operatives in the absence of other governance controls. It shows how current democratic processes have consistently generated a Group Board with acute and worsening failings. It demonstrates the systemic nature of these governance deficiencies and argues that a complete redesign of the Group's democratic structure is urgently needed and that incremental change will not suffice.

Chapter 5 sets out recommendations for a reformed Group Board, a new National Membership Council and extended membership rights. It explains in detail how these component elements of the proposed governance framework will create a fit-for-purpose Board with the requisite skills and experience, while ensuring that co-operative values and principles are fully protected, and that accountability to the entire membership is powerfully strengthened.

Chapter 6 sets out a transition plan with a clear implementation timetable and related interim structures that the Review proposes in order to achieve the necessary rapid pace of governance reform.

Chapter 7 provides some concluding reflections on the failure of governance at the Group and some implications for the future. In particular, it comments on the wider public policy angle and the consequences for the Group, its employees and its members of failure to act with sufficient decisiveness at this critical moment.

Lastly, this Review contains a full set of appendices that cover in more detail specific aspects of the governance reform task facing the Group. These include important sections on Board effectiveness, the economics of different ownership models and a comprehensive section on "Frequently Asked Questions".

## Exhibit 2 – TCG Values and Principles

### Co-operative values

- **Self-help** – we help people to help themselves
- **Self-responsibility** – we take responsibility and answer for our actions
- **Democracy** – we give our members a say in the way we run our businesses
- **Equality** – no matter how much money a member invests in their share account, they have one vote
- **Equity** – we carry out our business in a way that is fair and unbiased
- **Solidarity** – we share interests and common purposes with our members and other co-operatives

### Ethical values

- **Openness** – nobody's perfect, and we won't hide it when we're not
- **Honesty** – we are honest about what we do and the way we do it
- **Social responsibility** – we encourage people to take responsibility for their own community and work together to improve it
- **Caring for others** – we regularly fund charities and local community groups from the profits of our businesses

### Principles

- **Voluntary and open membership** – membership is open to everyone
- **Democratic member control** – all members have an equal voice in making policies and electing representatives
- **Member economic participation** – all profits are controlled democratically by members and for their benefit
- **Autonomy and independence** – co-operatives are always independent, even when they enter into agreements with the Government and other organisations
- **Education, training and information** – co-operatives educate and develop their members as well as their staff
- **Co-operation amongst co-operatives** – co-operatives work together with other co–operatives to strengthen the Co-operative Movement as a whole
- **Concern for community** – co-operatives also work to improve and develop the community, locally and internationally

Source: The Co-operative Group website

# Chapter 1: Summary of findings and recommendations

## *The context for this Review*

**1.1** The past few years have been the most tumultuous and challenging for the Co-operative Group in its entire 150-year existence. It was brought to the brink of collapse in 2013 by the emergence of near-catastrophic losses at The Co-operative Bank and a £1.5 billion capital shortfall. Rescued from this potential disaster by the exceptional efforts of a new Executive team led by Euan Sutherland, it then suffered further turmoil as the result of his sudden resignation, coupled with a series of boardroom leaks that threatened to destroy the Group's ability to govern and manage itself with any coherence and credibility. The Group has now announced a loss of £2.5 billion for 2013. This sequence of events has created deeply damaging uncertainty for its 90,000 employees and widespread concern among its millions of members and for all who care about the future well-being of the Co-operative Movement in this country.

**1.2** Numerous inquiries have been launched in a determined effort to learn the lessons from the calamitous failure of governance at The Co-operative Bank. In relation to the Bank, the Group is now subject to regulatory enforcement investigations by the Financial Conduct Authority, Prudential Regulation Authority and Financial Reporting Council. This massive failure of governance at the Bank, following the collapse of the Verde acquisition, is also the subject of Treasury Select Committee hearings.

**1.3** In August 2013, the new Executive commissioned an Independent Review, chaired by Sir Christopher Kelly, into the events leading to the near collapse of The Co-operative Bank. While his investigation was conducted in complete independence from my own work, the publication of his findings and recommendations have provided powerful confirming evidence of the depth of governance shortcomings that are laid bare in this Review. In particular, I wholly concur with his diagnosis that "*Failures in board oversight are inevitable if the criteria used to elect its members do not require those elected to have the necessary skills… Sustained success requires effective governance. Effective governance requires a high performing board. The composition of the Co-operative Board, and the limited pool from which its members were drawn, made a serious governance failure almost inevitable.*"[1] The Kelly Review contains further findings that closely match my own, and to which attention will be drawn in later sections of this Report.

## *The task of designing effective governance reforms*

**1.4** This is the challenging context in which my own Review has been undertaken. My central task has been to develop a set of recommendations that will get to the root of the governance problems that have so severely afflicted the Group. As the Review probed into the source of this dysfunctionality, it quickly became clear that the governance issues facing the Group are not confined to the failings of specific individuals but reflect deep-seated weaknesses across the Group's entire governance architecture. Replacing one set of Board members with another elected via the same electoral processes will not rectify the performance of a fundamentally flawed system.

**1.5** This conclusion has raised a further crucial consideration: how to design a new governance framework for the Group that fully respects the distinctive characteristics of the co-operative ownership model, its core values and underlying principles while

[1] Kelly Review (paragraphs 14.10-14.11).

simultaneously addressing the need to put in place a Group Board with the requisite skills and experience to achieve the high performance essential for success in the intensely competitive markets, such as food retailing, which form a large part of the Group's core business activities.

**1.6** To solve this problem, it became evident that the resulting governance solution would need to be innovative and, at the same time, offer compelling appeal – consistent with co-operative values – to the many millions of members who are loyal customers of the Group and who want it to survive and flourish. Throughout, this has been a core objective of the Review, with the parallel goal of creating a properly empowered membership body and respecting the co-operative principle of "one member, one vote" for all Individual Members, not just the 1 in 10,000 who are currently empowered to vote on the reform proposals outlined later in this Review.

**1.7** A further objective of this Review is to convince the present body of some 600 elected members to act in the best interests of the Group, and to set to one side the personal interests and benefits that they may have accumulated as a result of their involvement in the current electoral hierarchy. Many of these individuals have demonstrated long-standing commitment to the Group and to the values that, at its best, the co-operative ownership model can exemplify. Now, more than ever, a successful future for the Group is dependent upon their willingness to consider with an open mind the evidence for reform set out in this Review and the new framework of governance that I am proposing.

## *Reviewing the evidence for change*

**1.8** The main sections in this Report set out, step by step, the case for change. The Review first examines the present structure of the Board and the electoral system. Apart from a small minority of activist members, this has until very recently been poorly understood even within the Group, let alone by the outside world. The Review also considers the structure and implications of the three-tier electoral hierarchy and how that interacts with voting entitlements and eligibility for elected office. In particular, this raises the issue of whether such a system, widely categorised as labyrinthine in complexity, discourages individuals with talent but limited time from active participation and facilitates the entrenchment of a small number of powerful individuals.

**1.9** Given the long and distinctive history of the Group within the larger Co-operative Movement, it is important to understand the factors that have shaped the present distribution of governance powers. The Review examines these and concludes that because of deep concerns in the late 1990s about the need for predator protection against demutualisation attempts by outsiders, the resulting governance structure put in place in the merger between CWS and CRS in 2000 provided some genuine protection but at a heavy – and ultimately unacceptable – cost. In practice, this structure created a dysfunctional balance of authority between the Group Board and the Regional Boards. As a direct result, the Regional Boards acquired power without responsibility.

**1.10** Over the last 60 years, and in the face of severe competitive challenges, the Co-operative Movement has been characterised by endless delays in developing an effective response, with intense resistance to needed reforms, even when supported by accurate diagnoses and rigorous analysis. It was important for this Review to consider why this has been the case. In this section, the variety of ways in which continental co-operative movements have responded to the challenge of rising consumerism and the threats posed by the centralised business models of the multiple retailers are examined.

**1.11** All this provides a background for the detailed examination of the weaknesses of current governance practices within the Group. Chapter 4 provides painful, but regrettably essential, reading. In this chapter I catalogue a series of the major governance weaknesses that this Review has identified. These include four particular weaknesses of the current board structure: (a) inadequate collective capabilities and experience; (b) a widespread failure to understand the distinctive governance role of the board, and a tendency for lay directors to act as delegates more than independent representatives; (c) a lack of unified perspectives and shared purpose, given the frequent divergence of Regional concerns and pre-occupations; and (d) an excessively complicated structure with an unwieldy board size combined with gaps and overlaps in accountability with Subsidiary Boards and committees.

**1.12** This fact base sets the scene for the detailed explanation of our recommendations for reform, discussed in Chapter 5.

## *Summary of findings*

**1.13** To summarise my findings:

– The inescapable conclusion of this Review's analysis is that the present governance architecture and allocation of responsibilities is not fit for purpose. It places individuals who do not possess the requisite skills and experience into positions where their lack of understanding prevents them from exercising the necessary oversight of the Executive.

– Despite frequent references by elected members to the crucial need, in a co-operative, for democratic control, the reality has been quite different: the stark evidence is that there has only been a façade of control, and the individuals exercising it have been drawn from an excessively narrow pool of entrenched incumbents on the Regional Boards of the Group. The 15 so-called 'lay' directors on the current Board were in fact drawn from a total eligible pool of only some 35 Regional Board members. Quite apart from the lack of relevant skills and experience, this has not even been genuine democracy at work.

– This deeply flawed system of elected member representation has consistently produced governors without the necessary qualifications and experience to provide effective board leadership and to monitor, challenge and provide direction to management. This has massively raised the cost of decision-making and diminished genuine accountability throughout the Group's governance hierarchy.

– The result has been an inability to hold the Executive to account or to provide the guidance, motivation and counsel that any management team competing in this demanding competitive environment might reasonably deserve and expect.

– At the same time, the Group endures a significant "democratic deficit". Ordinary members have unexpectedly weak constitutional rights and limited ability to influence the Co-operative Group's social mission and activities to reflect their interests and values.

– It has become apparent in the course of this Review that a further important dimension of the co-operative model – the Group's social goals agenda – has become insufficiently aligned and connected with the achievement of its strategic and commercial objectives. This has led to poorly directed and sometimes questionable funding decisions. It is now evident that an important practical aspect of governance reform is the need for a full audit of controls over money spent on social goals and given to affiliated bodies.

## Specific reform objectives

**1.14** The task facing this Review has thus been to develop a reformed governance framework that addresses these crippling deficiencies. In doing so, it has to achieve three objectives:

- First, it has to produce a highly competent and qualified Group Board with independent non-executive directors who possess the skills and experience needed to exercise leadership and effective oversight of Executive management running a business of massive scale and complexity, quite unlike any other co-operative business in the UK. Unless the Group takes urgent steps to reform its governance and generate sustainable economic value, it will run out of capital to support its business. Value creation is the prerequisite for the organisation's survival, for value distribution to members and for the furtherance of desired social goals

- The second objective is to ensure that, without compromising the effectiveness of the Group Board, genuine co-operative values and principles are protected and securely embedded in the future governance architecture

- The third and equally important goal is to ensure that as a customer-owned organisation, the tangible benefits of membership are not deliberately restricted to a tiny and potentially quite unrepresentative body of elected members, but are extended so that the interests of the entire membership are properly understood and promoted and their fundamental rights are respected

## Developing a governance solution

**1.15** Developing a governance solution that meets these criteria for success is an intricate and complex task. In the face of a massive failure of governance the need for radical reform of the Group Board and the electoral hierarchy is indisputable. Yet within the elected membership, particularly at Group Board level and in the Regions, considerable resistance has been expressed to the reform proposals outlined in my Interim Report. In this section of the Review, I therefore summarise the key features of my recommendations and address, where appropriate, the principal objections that have been raised. I also make some concluding remarks about the Group's culture of governance that my reforms are intended to address.

## Reforming the governance structure

**1.16** The starting point for reforming the Group Board has been to focus on the core tasks and activities that it has to undertake and to identify the skills and experience required to fulfil them.

> **Reform the Group Board**
>
> **The Review's first proposal is the creation of a new Group Board made up of an independent chair with no previous association or involvement with the Group, six to seven independent non-executive directors and two executive directors. The non-executive directors will have the skills and experience of NEDs sitting on the boards of the Co-operative Group's primary competitors**

**1.17** At present, the composition of the Group Board includes 15 non-executive lay directors elected by individual Regions,[2] five non-executive corporate member directors elected from independent co-operative societies and, since December 2013, one so-called "IPNED", i.e. an independent professional non-executive director (the role to which I was appointed in December 2013).

**1.18** Embedding an ongoing distinction between independent, properly qualified and experienced directors (IPNEDS) and so-called "lay directors" is unhelpful and divisive. Looking ahead, any solution that attempts to perpetuate such a distinction runs the inevitable risk of tokenism towards the latter group and the deliberate creation of second-class citizenship within the boardroom. That is an unacceptable outcome.

**1.19** The Review is addressing this design challenge in two ways. The first component is to ensure that in future all appointments to the Group Board should be decided on the basis of objective criteria. These will be determined by the need to fill specific skill gaps on the Board that will equip it, in aggregate, to provide effective guidance and monitoring of executive management. Applicants for Group Board positions will, in addition, need to demonstrate strong commitment to co-operative values and principles. This will be an important dimension of the evaluation process and will be confirmed and underscored in their letters of appointment.

**1.20** On the basis of this approach, democratic control on the Group Board will be maintained in two ways: first, all non-executive directors will themselves be members committed to co-operative values and principles; and second, all such directors will be subject to triennial election/re-election by the entire membership.

**1.21** Further details on the composition and working of the Group Board are set out in Chapter 5.

## *Addressing objections to this proposal*

**1.22** The principal objection to this recommendation is that it would remove the right of lay directors to sit on the Group Board and exercise "democratic control". This objection is advanced as though the current composition of the Board, with lay director majority control is enshrined in the history of the Group's democratic practices. In fact, this arrangement is less than 15 years old, and dates from the merger of the Co-operative Wholesale Society ("CWS") and Co-operative Retail Services ("CRS") in 2000. Prior to that, a majority of the members of the Group Board of CWS were corporate members bringing commercial experience and representing the independent societies that had originally established CWS.

**1.23** At the root of this objection is the view that lay director control is a necessary requirement for the Group to function as a co-operative. But this is not the case. The key requirement is member control. Under the Review's proposals, this would be achieved in two complementary and reinforcing ways: first, all Group Board directors would be required to be members, and would have to demonstrate a genuine commitment to co-operative values and the co-operative ownership model; second, the entire membership would have an annual opportunity to elect/ re-elect individual directors to the Board. Members would also, in specific circumstances, have the right to nominate independent candidates who reach the requisite capability bar, for contesting individual board positions.

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[2] One Regional seat on the Group Board is currently vacant.

**1.24** A related objection is that a lay presence on the Group Board is necessary to ensure that members' interests are effectively represented at the highest level within the Group. Once again, however, the Review's proposals address this concern in a far more rigorous and systematic way through the creation of a National Membership Council. This forum will be specifically charged (as discussed below) with responsibilities for guardianship of co-operative values, for representation of members' interests and for ensuring that the Group Board and Executive are regularly held to account.

**1.25** A different objection that has been advanced in all seriousness is that the Review's proposals should be modified to allow for the presence on the Board of at least a token two lay directors, even if – on the admission of those proposing this amendment – such individuals quite evidently lack the relevant skills and experience for a particular Board position and would be nothing more than symbolic appointments.

**1.26** Those who advocate lay directors put it forward as a costless option. They never question whether it might degrade the quality of the decision-making on substantial issues. Yet this is to ignore the findings meticulously set out in the Kelly Review. Once again, I concur with his conclusion that: "*The Regional Representatives (i.e. 'lay directors') may be well-qualified to represent the views of members and customers, or to be guardians of co-operative principles. But Boards of major organisations have responsibilities which go much wider. Many of the individuals put much time and commitment into their role as Board members; but without appropriate skills and experience they are unlikely to be able to exercise appropriate oversight of a £13 billion conglomerate comprising such a disparate set of businesses.*"[3]

**1.27** To maintain that there are no economic costs to having unqualified directors on a Board of the Group's scale and complexity is to turn upside down a wealth of findings on effective board design around the world. And to insist on at least a token presence is akin to insisting that Manchester United should field a side which included at least three players from Rochdale F.C. (with no offence intended to supporters of either side).

**Establish an influential National Membership Council**

**The Review's second core recommendation is the establishment of a National Membership Council ("NMC") of around 50 individuals, including provision for representation of around 10 employees. The NMC will elect from its membership a Steering Committee of 12 which will also include corporate representation from independent societies**

**1.28** This new Council is a crucial pillar of the new governance structure. It will enable elected members to engage at the highest level with the Group Board and the Executive. It will have the following powers:

- First, to act as a consultative body that would regularly engage with the Group Board and hold it to account for its stewardship and strategic leadership of the organisation and for the operational performance of the Group
- Second, to provide a forum in which the interests of the Group's diverse membership can be represented and promoted
- Third, to serve as the guardian of the Group's commitment to co-operative values and principles and to ensure that these are reflected in its corporate vision, strategy and operating practices

3 Kelly Review (paragraph 14.12).

– Fourth, the right to appoint up to two representatives to sit on the Nominations Committee of the Group Board (see below)

**1.29** This new body would replace the current Regional Board structure which would be disbanded. Further details of its proposed working are set out in Chapter 5.

**1.30** In my Interim Report, I proposed an NMC of around 100 individuals. In response to practical concerns from TCG's elected membership about the effective size for such a forum with an expected quarterly meeting schedule, the Review now proposes this smaller size. There would continue to be a 12-strong Steering Committee drawn from the NMC, with membership as follows:

– Seven member representatives

– Two employee member representatives

– Three independent society representatives

The proposed responsibilities of the Steering Committee are discussed in more detail in Chapter 5.

**1.31** The main concerns expressed to the Review team about this proposal are that the NMC would be too large and that it would be little more than a talking shop.

**1.32** The reduction in size of the NMC is intended to address this first concern. The second issue is more fundamental. The innovation of creating a National Membership Council for the Group is a crucial component in the overall redesign of the Group's governance. The aim is to create a powerful consultative body that will be in a position to engage regularly and at the highest level with the Group Board and Executive. It will have its own secretariat and an ability to commission research specific to its remit. It will have an important role to play with regard to helping shape the Group's social agenda, and it will itself be held to account through its responsibility to produce an annual report to members. It is a crucial pillar in the new governance architecture.

**Create a Nominations Committee**

**The Review's third core recommendation is the creation of a Nominations Committee to screen and propose candidates for Group Board approval and for election/re-election by members at each AGM. The Committee would comprise five non-executive members, including up to two representatives designated by the NMC and the balance from the Group Board**

**1.33** This recommendation, and the reasons underpinning it, are discussed at full length in Chapter 5. The key point to be made clear in this summary is that the central purpose of the Nominations Committee is to identify the best possible candidates to fill specific non-executive positions on the Group Board which require the possession of those particular skills and experience that are needed to create a balanced mix of non-executive expertise, relevant to the Group's context and strategic objectives. The role of the Committee is to work in a completely impartial and objective manner to select the best candidate on a meritocratic basis against agreed criteria which relate to commercial acumen and affinity to TCG Values and Principles. In turn, on an annual basis the Committee is required to make a recommendation to members on the ongoing appropriateness of the Board's composition in relation to the needs of the Group. It is on the basis of this recommendation that individual Board members would put themselves forward for election/re-election at the Annual General Meeting.

1.34 The Nominations Committee is a crucial part of the governance architecture. It has serious work to do and will always aim to work via consensus. The recommendation to include in its composition two members designated by the NMC is specifically intended to build trust in the operation of the new governance framework. In light of the governance failures of recent years, it is important that members should feel complete confidence in the rigour and meritocratic processes that underpin future appointments to the Board.

If the NMC members of the Nominations Committee are unhappy with the process being followed or its output, they are free to raise this in the first instance with the Board and NMC and ultimately with the broader membership.

**Extend constitutional rights**

**The fourth core recommendation of the Review is to extend constitutional rights to the entire membership of the Group**

1.35 The fourth essential component of my reforms is to strengthen the rights of ordinary members. "One member, one vote" has been a core principle of co-operative ownership, yet at present ordinary members have very little power and I recognise that, aside from the influence of corporate members from the independent societies, the future of my recommendations lies in the hands of around 600 elected individuals on the current Group Board, Regional Boards and Areas Committees, few of whom have any serious business experience and many of whom are drawing financial and other benefits from their positions.

1.36 Under the Review's proposals, all Individual Members will be accorded important new rights such as the right to elect Group Board members, the right to attend Society General Meetings and to approve significant transactions, the right to approve the social goals programme, to elect NMC members and to propose candidates for the Group Board.

1.37 This recommendation is discussed at full length in Chapter 5, together with related recommendations designed to ensure that the Group's Register of Members is revised and upgraded and that measures are introduced, especially through the use of social media, to strengthen connectivity between the Group Board and Executive and the entire membership.

1.38 This summarises the four major reform proposals of the Review. However, these need to be considered in the context of the full set of 23 recommendations that are proposed. Collectively, these create an integrated framework to strengthen the governance of the Group; this framework is the result of careful design. It is not a menu of options. It balances different interests and considerations and will not be stable if it is implemented on a piecemeal basis.

## *Concluding remarks on the Group's culture of governance*

1.39 In my Interim Report I drew attention to a further set of governance weaknesses that can be categorised under the heading of "culture". The recommendations summarised above, if implemented swiftly, have the potential to achieve a rapid transformation of this culture. They will create a Group Board that is fit for purpose and an NMC that will provide a powerful forum for the representation of members' interests. However, in these concluding remarks I want to draw attention to four serious weaknesses in the present governance culture and emphasise the urgent need for these to change. These weaknesses are:

- Denial of responsibility
- Corrosive suspicion
- Procrastination
- Hiding behind values

## Denial of responsibility

**1.40** Throughout the work of this Review, this has been a constant refrain from elected members. All too often, when governance shortcomings have been raised, the response has been, "*No one told us. It was the fault of management. We were kept in the dark.*"

**1.41** This way of thinking reveals a deep misunderstanding of the nature of individual director responsibilities. If individuals felt unable to question and challenge management, they were not discharging their duties at the Board. Again, I am in agreement with Sir Christopher Kelly's view: "*It is not a legitimate excuse to claim, as some Board members have, that they were kept in the dark about what was going on in the Bank. Non-executive directors of major organisations have a duty of care which the members of the Group Board were not capable of exercising.*"[4]

**1.42** Despite the debacle at The Co-operative Bank and the clear evidence of governance failings at the level of the Group Board, there has been a general reluctance within the Board to openly acknowledge the role that directors collectively, and in some cases individually, have contributed to this outcome. It is hard to reconcile this denial of responsibility with the claim that the present governance structure has provided democratic control.

## Corrosive suspicion

**1.43** In my Interim Report I referred to the fact that there is a phrase frequently used in Co-operative Group circles that the Executive should be "*on tap but not on top*". This conveys an arrogant and dismissive attitude towards the role of management that is entirely misplaced. It is all the more inappropriate given the clear-cut evidence that in recent years the Board has collectively been out of its depth. It is also deeply regrettable, given the outstanding efforts that were made by the new Executive to save the Group last year. A well-functioning group of non-executive directors will strike an effective balance in its interaction with management: there will be tough questioning and sometimes relentless probing to get to the bottom of an issue in a constructive way; but there will also be wise counsel and support. Under the current arrangements, neither of these outcomes is achieved. All too often, the culture can best be described as "*Them and Us*".

**1.44** Suspicion is not confined to the interaction between the Group Board and the Executive. It is also prevalent in relations between lay directors on the Group Board and their Regional Boards. In this connection, I note the comments of Patrick Gray, President of Midcounties Co-operative in a recent Guardian article when he stated, "*real power lies not in the hands of members, but with those who spend their lives watching their backs in a hierarchy of committees, locking out new blood…*".[5] Certainly, the failure to have clear

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4 Kelly Review (paragraph 14.13).
5 Guardian (3 April 2014).

agreement on the dissemination of confidential Group information to Regional Boards places Group Board directors in a frequently invidious position of divided loyalties. This is further accentuated by the requirements of "concurrency" whereby Group Board members have to retain seats at each level within the three-tier electoral hierarchy and are therefore required, in some cases, to campaign for office every year.

## Procrastination

**1.45** A culture of delay pervades the present governance of the Group. Even relatively straightforward decisions for the Board frequently require reversion to Regional Boards. While no doubt some would argue that this is the legitimate expression of co-operative governance, all too often this is a deliberate tactic to defer decision-making where painful but unavoidable trade-offs need to be made. The hallmark of an effective board is one that, armed with the best available information, and equipped with a wealth of individual skills and experience, is willing to make judgements based on less than complete knowledge. In an intensely fast-moving competitive environment such as food retailing, it is often simply not possible to secure the best opportunities if the decision-making process is far slower than one's rivals.

## Hiding behind values

**1.46** One of the most frequently used expressions in any discussion of governance within the Co-operative Group is reference to "Values and Principles".[6] This can sometimes refer to the formal statement of these by the International Co-operative Alliance ("ICA"). But the phrase is often used in a more generic sense, almost as a debating tool, to silence opposition and to defer consideration of painful choices. This has created a serious governance problem: the assertion of Values and Principles is often advanced, without adequate specificity, to deflect or stifle criticism. Yet as one commentator has expressed it, "*How valuable are values (or even Values) if they destroy value?*"[7] This brings us back to the core issue of this Review: unless the Group is able to organise its governance effectively so that it can provide disciplined scrutiny and sound guidance to the Executive, it will not be able to create economic value for its members, and without that its future is bleak.

## Conclusion

**1.47** This completes the summary of the Review's findings and recommendations. The challenge ahead is to achieve radical structural reform of the Group's governance, and thereby to secure fundamental changes in its governance culture. The evidence in support of these conclusions is set out in the remainder of this Review together with a transitional plan and a recommended timetable for urgent implementation.[8]

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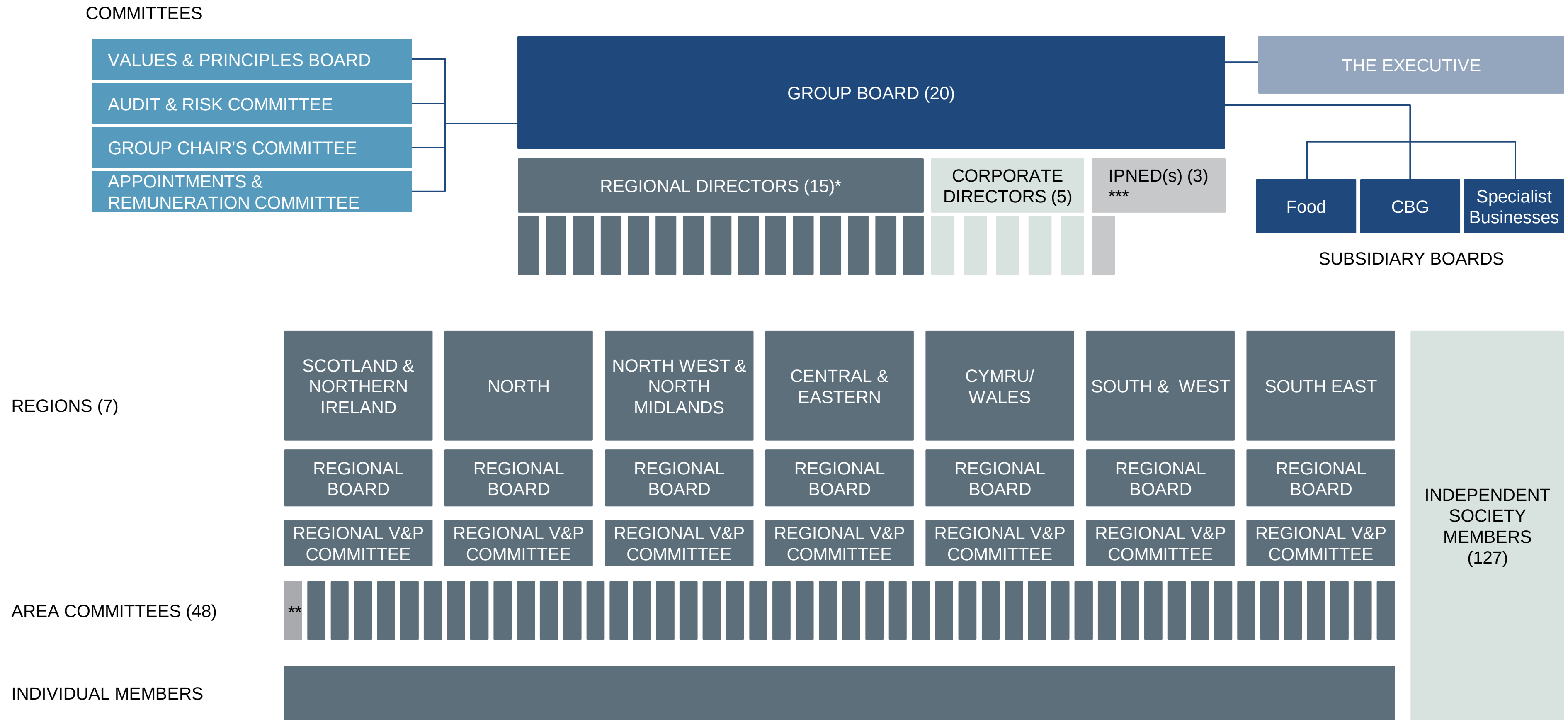
6 See Exhibit 2.
7 Daily Telegraph, C. Moore 12 April 2014 (p. 24).
8 See Chapter 6.

## Exhibit 3 – Current structure of the Co-operative Group




*One seat is currently vacant
**Northern Ireland Members Council
***The Group Board may appoint up to three IPNEDs

Source: TCG's Rules and Regional Regulations

# Chapter 2: The current governance structure

## *Introduction*

**2.1** TCG's governance structure is highly complex and has frequently been criticised as "*opaque*" and "*Byzantine*". The current arrangements reflect its progressive transformation from a wholesale society owned by independent retail society "corporate" members into a hybrid body with a majority of individual customer members.

**2.2** TCG's governance structure is correspondingly divided into two categories:

- For Individual Members: A three-tier structure comprising the Group Board, seven Regional Boards (Central & Eastern, Cymru/Wales, North, North West & North Midlands, Scotland & Northern Ireland, South & West and South East) and 48 Area Committees[9] (within TCG, the branch representing Individual Members is commonly called the "Regions")

- For Independent Society Members: A much simpler arrangement where a direct relationship exists between the Group's 127 Independent Society Members and the Group Board

**2.3** This chapter focuses principally on the three-tier democratic edifice for Individual Members because this is the primary source of governance complexity. Specifically, it examines in turn:

- The Group Board

- The supporting electoral hierarchy

- Membership

## *The Group Board*

**2.4** The Group Board sits at the apex of the Group's governance system. Its composition is the outcome of a series of compromises and negotiations, particularly the felt need to provide voice for its varied constituencies and communities. Hence, the Group Board has been characteristically large, ranging from over 30 members to 21 members at present.[10]

**2.5** The remit of the Group Board largely resembles counterparts at other commercial organisations, including strategy setting, senior-level appointments, performance monitoring and approval of significant capital expenditures and transactions. Certain responsibilities of the Group Board cannot be delegated under the Rules (see Exhibit 4).

| **Exhibit 4 – Rules setting out the non-delegable responsibilities of the Group Board** |
|---|
| – Deciding the vision and strategy of the Society and its businesses in consultation with the Subsidiary Boards, and having regard to the nature and extent of its interest in all of its businesses |
| – Ensuring, whether directly or through other people, that the Society's businesses and affairs are conducted and managed in accordance with its Purpose and Objects, and in accordance with the best |

[9] Including the Northern Ireland Members' Council.
[10] Out of the 21 allocated seats on the Group Board, one Regional seat is currently vacant.

| | |
|---|---|
| | interests of the Society and its Individual Members and Independent Society Members |
| – | Monitoring the Society's businesses |
| – | Overseeing the Group Chief Executive and the other members of the Executive as they carry out their roles |

Source: TCG Rule 2.10

2.6 The Group Board ordinarily comprises 15 directors representing Individual Members (commonly referred to as "Regional" or "lay" directors), five directors representing independent societies (also known as "Corporate directors") and up to three independent professional non-executive directors ("IPNEDs"). Only one IPNED appointment has ever been made on the Group Board.

2.7 Due to the historical – if now diminishing – concern that the Board's ability to "control" management would be weakened if executives were to sit on the Group Board, no member of the management team (collectively referred to as the "Executive") is allowed under the Rules to be a Group Board director.

2.8 The 3 to 1 ratio between Regional and Corporate directors was decided during the Constitutional Review that followed the merger between TCG and United Co-operatives in 2007, based on their respective proportions of trading activity with the Group at that juncture (and which have remained relatively stable over time).

2.9 The 15 directors representing Individual Members are appointed for three-year terms via competitive Regional elections,[11] with the following distribution of seats among the seven Regions:

| Region | No. of directors |
|---|---|
| Central & Eastern | 2 |
| Cymru/Wales | 1 |
| North | 3 |
| Northwest & North Midlands | 3 |
| Scotland & Northern Ireland | 2 |
| South & West | 2 |
| South East | 2 |

The allocation of Regional seats on the Group Board reflects the proportionate sales per Region in the customer-facing businesses (excluding financial services) at the time of the 2007-2009 Constitutional Review.

2.10 The five directors representing independent societies are also appointed for three-year terms but are chosen through competitive national elections. Under the Rules, directors, board secretaries, chief executives and senior managers of Independent Society Members are eligible to run for the Group Board. In practice, these seats are nearly always occupied by the chief executives of the largest Independent Society Members.

[11] Individual seats, however, are not always contested.

**2.11** Currently, the chief executives of Central England Co-operative, Lincolnshire Co-operative, Midcounties Co-operative, Scottish Midland Co-operative and The Southern Co-operative represent the Corporate constituency on the Group Board.

**2.12** In the event of the need for IPNEDs being identified, they are appointed for terms of up to three years by the Group Board, subject to ratification by the delegates at the first-convened Society General Meeting following their appointment.

**2.13** The constituency-based, competitive system for electing Group Board members differs markedly from the practice at large UK listed companies and building societies, where a nominations committee is charged with developing a customised matrix of skills and experience required by the board and then proposing candidates that best match the agreed criteria for board appointment and subsequent election by shareholders or members.

**2.14** Instead, TCG's electoral model pays no attention to the specific expertise required by the Group Board. The Rules, however, provide for up to three IPNEDs to be appointed to fill gaps – as identified through an annual skills audit – in board competence. The Review team has been informed that such an assessment has never been completed.

**2.15** Moreover, constituency-based, competitive elections mean that, unlike listed companies where board members are able to focus singularly on furthering the interests of the entire organisation, Group Board members are, in practice, expected to promote and represent their individual constituency interests rather than solely those of the Society. This tension exists even though the law and TCG's Rules and Regulations state unequivocally that the overriding duty of directors is solely to the Society.

**2.16** Group Board directors retire by rotation, with the effect that around one-third of them are up for re-election each year. Group Board members cannot serve more than three consecutive terms. However, agreement made during the 2007-2009 Constitutional Review to disregard service on the Group Board prior to the Annual General Meeting in 2009 has resulted in several board members continuing to sit on the board even though they have served more than three consecutive terms.

**2.17** The Group Board has several committees – Group Chair's, Group Audit and Risk and Group Remuneration and Appointments – that are commonly found in large commercial organisations. Their responsibilities are summarised below:

| Committee | Role |
|---|---|
| Group Chair's | Acts on behalf of the Group Board between board meetings on all matters reserved for the Group Board |
| Group Audit and Risk | Oversees the preparation of accounts, monitors financial performance and control systems and co-ordinates the work of the audit committees of subsidiaries |
| Group Remuneration and Appointments | Makes recommendations on the remuneration of the Group's senior employees and succession planning, reviews the remuneration and expenses policy of Group Board directors and co-ordinates the remuneration and appointments policy across TCG and its subsidiaries |

**2.18** The Group Chair's committee comprises the Group Chair, the Deputy Chair(s), Chair of the Values and Principles Board and Chair of the Remuneration and Appointments committee. The other two board committees are populated by Group Board and Subsidiary Board members, all of whom are appointed by the Group Board.

**2.19** In 2013, the Group merged four committees – Group Values and Principles, Governance, Diversity Strategy and Political Strategy – into a newly created Values and Principles Board. It is charged with considering and making recommendations to the Group Board, Subsidiary Boards and Group Board committees on a number of matters, including Group Board and Regional governance issues, member engagement, social goal strategies, Group distribution strategy, TCG's relationship with political parties and diversity issues.

**2.20** The Values and Principles Board comprises representatives from each of the seven Regions and one member representing independent societies.

**2.21** In addition, TCG owns, controls and co-ordinates its businesses through the following legally constituted subsidiaries: Co-operative Banking Group Limited[12] ("CBG"), Co-operative Specialist Businesses Limited ("Specialist Businesses") and Co-operative Food Holdings Limited ("Food"). Each entity has a Subsidiary Board, the members of which are appointed by the Group Board.

**2.22** CBG pre-dates the CWS-CRS merger (it was previously known as Co-operative Financial Services Limited). It continues to hold TCG's shareholding in the Bank. The Food and Specialist Businesses boards were established during the 2007-2009 Constitutional Review to improve oversight of these businesses – through allocating more time to them and appointing IPNEDs with relevant business background.

**2.23** Each Subsidiary Board consists of a mixture of Group Board members, Group executives and IPNEDs, all of whom are appointed by the Group Board.

## *The supporting electoral hierarchy*

**2.24** TCG's Regional electoral hierarchy beneath the Group Board comprises seven Regions and 48 Area Committees (including the Northern Ireland Members' Council). The electoral system also features a complex array of voting mechanisms, tenure qualifications and concurrent office-holding requirements designed, in part, to ward off carpetbaggers.

### *Regional Boards and Area Committees*

**2.25** Each of the seven Regions has its own board. Although they are known as "boards", the Regional bodies are not affiliated with separately constituted legal entities. Regional boards were established as a way to imitate the structure of TCG's founding members, the independent societies.

**2.26** Under the Rules, the seven Regional Boards have the following business responsibilities:

- Receiving and monitoring trading information
- Approving certain management proposals, including relating to certain capital expenditure matters and closure of core trading units in their individual Regions

12 CBG is the umbrella holding entity for the Group's financial services-related businesses, including CIS General Insurance Ltd, Co-operative Insurance Society Ltd and the Group's stake in The Co-operative Bank p.l.c. Among CBG's wholly-owned subsidiaries, only CIS General Insurance Ltd and Reclaim Fund Ltd are regulated.

– Making recommendations to the Group Board with respect to the development of their individual Regions

Elected members believe it is essential to hold management to account at every level of the business. Hence, Regional Boards view scrutinising Regional businesses as an integral part of their role.

**2.27** Additionally, Regional Boards are charged with the operation of certain democratic processes, including overseeing Regional elections and Regional Meetings and organising delegations to Society General Meetings and meetings of affiliated organisations.

**2.28** Arguably, their most critical role relates to the Regional block voting at Society General Meetings (as further discussed below) and the pressure they exert on Group Board directors to prioritise Regional interests.

**2.29** Each Regional Board consists of 12 to 15 members, elected for three-year terms by Area Committee members in the Region. Regional Board seats are allocated in one of two ways:

– All seats are allocated to individual Area Committees, with the provision that every Area Committee within the Region has at least one seat

– Each Area Committee in the Region is allocated at least one Regional Board seat, with any remaining seats filled by a general election within the Region

**2.30** In addition, each Region has a Regional secretary, a Regional office consisting of 6 to 12 staff and a Regional Values and Principles committee.

**2.31** The "front-line" tier of the electoral hierarchy consists of 48 Area Committees distributed among the seven Regions as follows:

| Region | No. of Area Committee |
|---|---|
| Central & Eastern | 5 |
| Cymru/Wales | 4 |
| North | 9 |
| North West & North Midlands | 8 |
| Scotland & Northern Ireland | 10 |
| South & West | 7 |
| South East | 5 |

**2.32** The Area Committees are intended to represent Individual Members and their interests and promote their participation within the Group. Each Area Committee has 10 to 12 members,[13] elected for three-year terms by Individual Members residing within its boundaries. In total, there are approximately 600 individuals holding office at Area Committee level.

13 The Northern Ireland Members Council may comprise up to 20 members.

**2.33** Crucially, out of a membership of 8.1 million, only Area Committee members are allowed to nominate and elect candidates to the seven Regional Boards and to the 15 seats designated for Individual Members on the Group Board. The concentration of power among this small group means essentially that only one member out of 10,000 is fully enfranchised and that Group Board members are chosen by an electorate of, on average, fewer than 100 members per Region.

**2.34** Regional Board and Area Committee terms are staggered, with the result that approximately one-third of members on each body are up for re-election each year. There is no limit on the number of terms that Regional Board and Area Committee members can serve.

### *The electoral process*

**2.35** In addition to the multiple categories of Group Board directors, competitive elections and multiple governance tiers, the electoral hierarchy is further complicated by the voting mechanisms employed in elections and at Society General Meetings and by the tenure and concurrent office holding requirements.

**2.36** The voting mechanisms presently in use are summarised below:

| Purpose | Description |
|---|---|
| Area Committee elections | – One member, one vote for all Individual Members in that Area |
| Regional Board elections | – If seat is contested within an Area Committee: each Area Committee member has one vote<br>– If seat is contested within the Region: *either* each Area Committee member has one vote *or* votes weighted by relative Area purchases and distributed evenly among Area Committee members, at the discretion of the Regional Board in each Region |
| Group Board (Regional elections) | – Within relevant Region, votes allocated to Area Committees according to purchases and then distributed evenly among Area Committee members |
| Group Board (Corporate elections) | – Each Independent Society Member is allocated one vote plus the relevant number of votes based on their purchases, further to which these are cast as a block by the Independent Society Member |
| Society General Meetings | – Show of hands (i.e. one delegate, one vote) or a poll vote (weighted voting based on purchases) |

Source: TCG Rules, Regional Regulations, Group Board Election Regulations

**2.37** Notably, the Group has moved away from the traditional one member, one vote approach and employs purchases-based weighted voting in a variety of situations. Furthermore, the delegates for each Region will vote as a block on matters to be decided on a poll at a Society General Meeting.

**2.38** Each year, the relative share of votes that each Region and each Independent Society Member is allocated for votes based on purchases is calculated by TCG's Finance department, based on trading figures from certain business sectors during the previous financial year. The calculation process appears to be highly opaque, worked out by TCG's Finance department with no publication of the formula or voting rights within Regions or to the membership. The Review team has been told that one reason for the lack of clarity and non-disclosure of weighted voting rights is that it is used as a deterrent to demutualisation. While the Group Board has no remit to change the apportionment of additional voting rights, external auditors examine the voting figures annually.

**2.39** Votes are undertaken in two ways at Society General Meetings: a show of hands[14] (one delegate, one vote) or a poll vote (weighted voting based on purchases). In practice, a show of hands is used for routine matters and a poll vote for significant matters. Certain decisions – such as amendments to the Rules – must be taken by poll under the Rules. In addition, the Chair of the general meeting, the Group Board or a prescribed number of Regions and Independent Societies can demand a poll vote.

**2.40** Resolutions at Society General Meetings are generally passed by a simple majority of the votes cast. A notable exception is a resolution to amend the Rules, which must be passed by a two-thirds majority of votes cast on a poll. Under industrial and provident society legislation, there are a number of matters that require special resolution procedures, such as an amalgamation of two or more societies, a transfer of engagements between societies, a conversion into a company or dissolution of a society. The procedure and threshold for special resolutions are specified in each section of the legislation. Few of the special resolution procedures or thresholds required by the legislation are expressly set out in the Rules. Instead, the Rules state that the default simple majority voting threshold is also subject to any voting thresholds required by the law.

**2.41** At Society General Meetings, Regional Delegates cast their votes as a single block: for a vote on a show of hands, Regional Delegates are bound by the elected members' Code of Conduct (set out in the Regional Regulations) to vote in accordance with a Regional mandate (if there is one), and on a vote to be decided by a poll, the Regional Board chair for each Region will cast the Region's votes as a single block in accordance with the pre-agreed stance of his/her delegation. The mechanics of block voting, requiring an agreed position before the start of a general meeting, appear to make debate during the actual meeting much less consequential.

**2.42** The voting strength of individual Regions range from approximately 5 percent to 14 percent. For constitutional changes where two-thirds majority support is required, this means a coalition of three or four Regions can effectively determine the outcome of constitutional reform.

**2.43** A distinguishing feature of TCG's governance is the membership and office tenure requirements woven into the three-tier structure. Specifically, those running for elected offices confront the following tenure requirements:

| Position | Requirement |
|---|---|
| Area Committee member | A candidate must have been an Individual Member for the immediately preceding 12 months |
| Regional Board member | A candidate must have been an Area Committee member for the immediately preceding 24 months |
| Group Board director | A candidate must have been a Regional Board member for the immediately preceding 24 months |

**2.44** The practical implication is that it takes a new member at least five years to rise to the Group Board. This means that the "churn" of elected members, particularly at the Group Board, is designed to be slow. The Review team has been told that these tenure requirements have been put in place to discourage carpetbaggers, to develop individuals

14 This is now executed via the use of hand-held terminals.

as they take on greater responsibility and to provide the electorate with candidates that they know. However, they have also undoubtedly dissuaded individuals "*with skills but not time*" – particularly younger members and those with care-giving responsibilities – from becoming involved in the upper echelons of the organisation.

**2.45** In addition, a Group Board director representing Individual Members is required to hold all three offices (Group Board, Regional Board and Area Committee) concurrently. For a Group Board member, losing office at Area Committee or Regional Board level would therefore lead to him or her resigning from the Group Board as well.[15] Because the terms for the three offices do not expire at the same time, Group Board members must contend with frequent re-elections (as often as annually) even though each office has a three-year term. Board members told the Review team that last year, due to the rhythm of the tiered elections, half the directors were at risk of losing office. The election timetable is set out in Exhibit 5.

**Exhibit 5 – Timetable of elections for Group Board directors under current governance structure**

GB: Group Board election
RB: Regional Board election
AC: Area Committee election

| | Year | | | |
|---|---|---|---|---|
| **Region** | **2014*** | **2015** | **2016** | **2017** |
| **South & West** | | | | |
| Director 1 | | GB AC | RB | |
| Director 2 | | RB | GB AC | |
| **North** | | | | |
| Director 1 | RB | AC | GB | RB |
| Director2 | RB AC | | | GB RB AC |
| Director 3 | | GB RB | AC | |
| **N. West and N. Midlands** | | | | |
| Director 1 | RB | AC | GB | RB |
| Director2 | RB | AC | | GB RB |
| Director 3 | RB | GB AC | | RB |
| **Scotland & N. Ireland** | | | | |
| Director 1 | | GB RB AC | | |
| Director2 | | RB AC | | GB |
| **Central & Eastern** | | | | |
| Director 1 | AC | GB RB | | AC |
| Director2 | | RB AC | GB | |
| **South East** | | | | |
| Director 1 | | AC | RB | GB |
| Director2 | | RB AC | GB | |
| **Wales/Cymru** | | | | |
| Director 1 | RB AC | | | GB RB AC |

* After 17 May 2014

Source: TCG Membership team

15 Correspondingly, a Regional Board member is required to concurrently serve as an Area Committee member.

2.46 Group Board members are remunerated for each role that they take on as set out below:

| Role | Annual remuneration (2013) |
|---|---|
| Area Committee member | £2,000 – £3,000 |
| Area Committee chair | £2,000 – £3,000 (additional) |
| Regional Board member | £4,500 – £5,000 |
| Regional V&P Committee | £500 – 700 |
| Group Board member | £11,574 |
| Group Board Chair | £120,368 |
| Group Subsidiary Board member | £11,574 |
| Group Subsidiary Board chair | £11,574 (additional) |
| Group Board Committee member | £1,157 – £5,787 |

Source: TCG annual reports and publicly available elected office candidacy material

All current Group Board members sit on an Area Committee and Regional Board and many also take on other paid governance roles either on Group Subsidiary Boards and committees and/or on the boards of sister organisations. In 2013, the range of remuneration for lay board directors for TCG governance roles was between £18,000 (for part of the year) and £44,000.

2.47 There has historically been anxiety within TCG about employee involvement, driven by a fear that they could "*rig the election process*" and "*engineer a takeover*" which would replace the consumer co-operative model with an employee owned model. The Rules provide protection against such occurrences by limiting the number of employees on the Area Committees and Regional Boards to one third of the total and the number of Regional representatives on the Group Board who are employees to four. Currently there is one Group Board member who is also an employee although others have been TCG employees in the past.

## Membership

2.48 TCG has 8.1 million members, although – due to gaps in its records (such as not accounting for deceased members or not having members' addresses) – this number is not fully verifiable. This tally includes those whose membership was transferred from entities with whom the Group had merged, such as Britannia Building Society and United Co-operative Society.

2.49 While the vast majority of TCG members are individuals, its membership register also includes approximately 130 corporates. The most prominent members in this category are large regional independent co-operative societies – such as Central England and Midcounties – that engage in diverse business activities. The large independent societies all participate in the pooled buying arrangement (Co-operative Retail Trading Group or "CRTG") administered by the Group and collectively account for some 95 percent of non-TCG purchases.[16] Other, smaller corporate members include co-operatives engaged in farming and a mix of specialised entities such as The Phone Co-op, most of which have

16 TCG, however, accounts for the bulk of CRTG purchases.

little or no commercial interaction with the Group. Around 15 foreign co-operatives, including the Swiss Coop Group, are also found in TCG's membership ranks. Lastly, several non-commercial societies such as the Co-operative College Trust, Co-operatives UK and the Co-operative Party are members.

**2.50** An individual wishing to become a member must complete an application form and agree to subscribe for a minimum of one £1 individual share (which amount can be deducted from the member's dividend). Once a member has been issued with a membership card, it is valid forever. Although the Rules permit individual memberships to be revoked due to inactivity, this is not routinely done.

**2.51** Any corporate entity making an application for membership as an Independent Society Member must apply for and, on admission as an Independent Society Member, immediately take up the number of £5 corporate shares determined by the Group Board, such number usually being proportionate to the number of the applicant's own members as at the date of application.

**2.52** Like many co-operatives around the world, a member's right to the Group's profit is determined based on his or her transactions with the Group rather than on the proportion of shares subscribed. Exhibit 6 shows how points are earned by members.

**Exhibit 6 – How points are earned by members**

| Business | Points Structure |
|---|---|
| Food | £1 = 1 point |
| Bank (current account)* | 1,200 points per year |
| Bank (mortgage)* | 750 points per year |
| Bank (ISAs)* | 300 points per year |
| Bank (all other products)* | 100 points per year |
| Insurance (home) | 100 points on taking out the product. 750 on renewal |
| Insurance (motor) | 100 points on taking out the product. 750 on renewal |
| Insurance (pet) | 100 points per year |
| Legal Services (wills) | £2 = 1 point |
| Legal Services (conveyancing) | 250 points |
| Pharmacy | £1 = 1 point |
| Funeralcare | £1 = 1 point |
| Funeralcare (funeral plans) | 2,500 points |
| Funeralcare (memorial masonry plans) | 500 points |
| Electrical | £1 = 1 point |
| Travel | £2 = 1 point |

* The allocation of points for Banking transactions is currently under review
Source: Membership Marketing, September 2013

**2.53** In 2013, 5.7 million of TCG's members (4.6 million if transactions with the Co-operative Bank are excluded) transacted with one or more businesses in the Group. Historically, approximately 3 to 4 million members have transacted with the Group in sufficient amounts to qualify for a dividend.

**2.54** The Group maintains a complex relationship with Independent Society Members. Some independent societies perceive TCG as a competitor in businesses such as food retailing, funeralcare, pharmacies and travel, and view their relationship largely in commercial terms. Others, including some who compete directly with the Group, feel a strong sense of solidarity with TCG and view it as the leader of the UK Co-operative Movement.

**2.55** Compared with other co-operatives and investor-owned companies and, in conflict with the stated principle that "*all members have an equal voice*", the ordinary members of TCG have surprisingly weak rights. To illustrate this:

- Individual members are not permitted to requisition, attend, submit motions or vote at Society General Meetings
- At Society General Meetings, Individual Members are represented by Regional delegations while each Independent Society Member is permitted to send its own Delegates. The number of Delegates allowed for each Region or Independent Society Member is based on "purchases",[17] with a minimum of two Delegates and a maximum of 18 Delegates
- Individual Members are permitted to elect Area Committee members only. As explained previously, the right to elect Regional and Group Board members resides with Area Committee members
- Individual members do not have approval rights in relation to major acquisitions or disposals

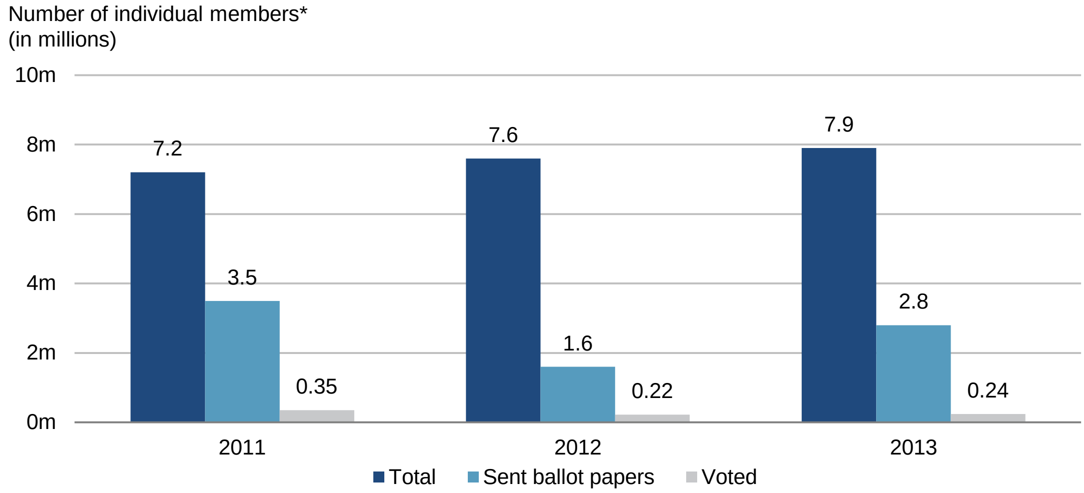
**2.56** For all but a tiny minority of Individual Members (fewer than one in 10,000), formal voting is largely restricted to selecting Area Committee members. There is no direct right to elect Group Board directors. In 2013, 2.77 million members received ballot papers for Area Committee elections, based on their:

- having been elected members; or
- having accrued a minimum of 250 trading points in 2012 and having voted at least once in the last three elections; or
- having opted to receive ballot papers following an e-mail invitation.

**2.57** Out of this total figure, nearly 238,000 members voted. This translates to a participation rate of approximately 8.5 percent (based on members who received ballot papers) or around 6.0 percent (based on those who were also offered an opportunity to request ballot papers but did not respond) or nearly 3.0 percent (based on total membership of 8 million). TCG voting turnout is comparable to building societies such as Nationwide and to other UK consumer co-operatives.

[17] The definition of "purchases" is determined by the Group Board and presently includes categories such as food purchased through the Co-operative Retail Trading Group, petrol, healthcare, and funerals.

## Exhibit 7 – Voting turnout for Area Committee elections




* At the time of election
Source: TCG Membership Team Feb 2014; Annual Reports 2011, 2012 and 2013

**2.58** We now turn to how TCG's history has shaped its governance system and contributed to its acute systemic weaknesses.

# Chapter 3: How the Group's governance system has evolved

## Introduction

3.1 The Co-operative Group is dominated by the weight of tradition and inherited beliefs about its own distinctiveness. That, at least, is the common characterisation of its elected members in the extensive literature on the Group's performance over the last 60 years. Understanding this context is correspondingly a pre-requisite for the development of constructive proposals for governance reform.

3.2 This chapter correspondingly addresses four questions:

- First, what accounts for the complex governance structure described in the previous section, and in particular the crucial role of the Regional Boards in determining the fate of any reform proposals?
- Second, and more fundamentally, what insights can we draw from examining previous efforts to reform the overall governance of the Co-operative Movement since the high point of its market dominance in the late 1940s?
- Third, what lessons can we also learn from comparison with co-operative movements internationally?
- Finally, what are the implications for reform today?

## Explaining the Group's current governance structure

3.3 The essential starting point is to recognise that the present structure reflects a transformation of the Co-operative Group's ownership that has taken place over the last 150 years. It was established in 1863 as the Co-operative Wholesale Society ("CWS") with the explicit function of pooling the collective buying power of the separate consumer co-operatives that had developed in the 1840s and 1850s from the efforts of the Rochdale Pioneers and others. At the outset, CWS was thus entirely owned by corporate shareholders, the primary consumer co-operatives. It had no individual customer members. Instead, there was a commercial relationship between the primary consumer co-operatives and CWS: it bought, and increasingly manufactured, goods and supplies to sell to these retail societies, but, despite being part of a collective Co-operative Movement, it had to compete fiercely for their custom against other wholesalers. This kept it innovative and entrepreneurial during its crucial formative years in the latter part of the nineteenth century when the Co-operative Movement as a whole dramatically increased its collective share of the UK retail market. As one recent account summarises it, "*From humble origins the CWS grew into one of Britain's largest businesses within a generation, pioneering modern retailing and distribution on a national scale*".[18]

3.4 The Independent Societies who currently retain five seats on the Group Board and 22 percent of the voting rights of the Co-operative Group are the distant, residual legacy of this original ownership structure.

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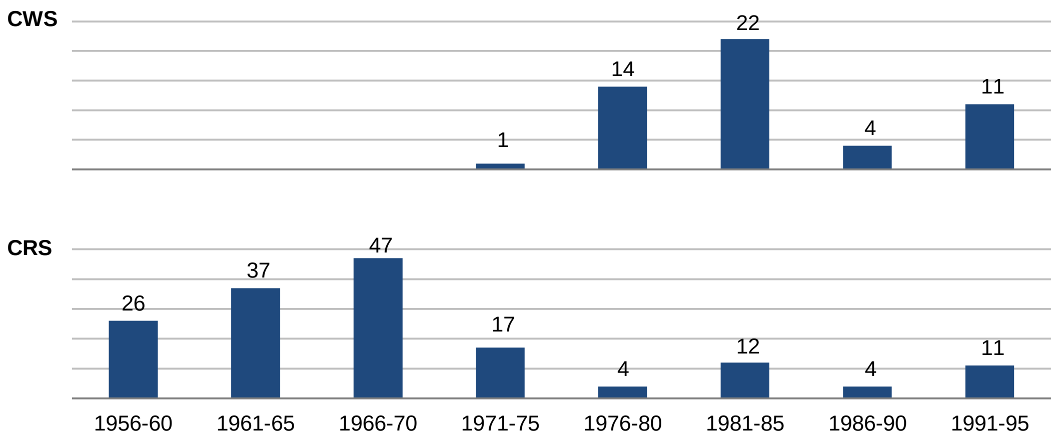
18 Wilson, Webster & Vorberg-Rugh Building Co-operation: A Business History of The Co-operative Group, 1863-2013 (p. 2).

**3.5** It is individual consumers who now comprise the vast majority of the Co-operative Group's membership, as it has progressively transformed itself from a wholesale "secondary" co-operative into a predominantly consumer "primary" co-operative. Yet the final transition to majority control by Individual Members, with all its profound implications for the Group's governance, is a recent event in the Group's long history. It only dates from 2001, and correspondingly the Group has been subject to this particular form of majority "lay director" control for less than 15 years.

**3.6** What took place in 2000 was the merger between CWS and Co-operative Retail Services ("CRS"). This was the culmination of a protracted effort to bring together the disparate retail networks that CRS and CWS had each developed. CRS had its origins in the early 1930s when it was established as a subsidiary of CWS to develop new primary societies in parts of the UK where the Co-operative Movement as a whole had limited coverage – so-called "co-operative deserts". This led, for example, to expansion in the South East and South West where co-operative activity had historically been relatively low. However, the role of CRS changed significantly over time as, from the 1950s onwards, increasing numbers of individual societies became unprofitable. CRS then began to act as what was termed "the ambulance service" for loss-making co-operatives, amalgamating them into its own retail activities through transfers of engagement. As more and more consumer co-operatives failed, consolidation continued in the 1960s and 1970s, to the point at which CRS itself began making losses and, after tortuous negotiations, finally agreed to be re-absorbed back into CWS, to form the Co-operative Group.

**3.7** CWS had itself become directly involved in retail activities from 1973 when it rescued the Scottish CWS from a crisis in its bank subsidiary and the risk of liquidation. As a result of the merger, it took on the SCWS's existing retail network. This was soon followed by further rescues of failing societies at a pace that stepped up as CRS had to scale back its ambulance service because of its own financial weakness. The combined scale of these rescue efforts is shown in Exhibit 8.

**Exhibit 8 – Co-operative retail societies merging with the CRS and CWS (1956-1995)**




Source: Wilson, Webster & Vorberg-Rugh, Building Co-operation: A Business History of the Co-operative Group, 1863-2013 (Table 7.3, page 288)

**3.8** This corporate history provides the essential context for understanding the complexity of the Group's current governance arrangements. As failing individual societies negotiated to transfer their engagements to CWS, the consolation prize that individual board members and chief executives frequently received was the offer of director positions on Regional Boards in the localities where they had previously run independent societies. (Their residual governance role has also persisted in connection with certain responsibilities for business oversight and with regard to capital expenditure and closures.) Of course, in a few instances individual societies merged from positions of equivalent strength to CWS. This was in fact the case with the most recent significant amalgamation, the merger between CWS and United Co-operative, which took place in 2007. Nevertheless, as a broad generalisation, today's seven Regional Boards are predominantly the organisational heirs of yesterday's numerous failed consumer co-operatives.

**3.9** The Co-operative Group's current governance structure has correspondingly resulted in a Board composition that is fundamentally different from its original configuration when it consisted entirely of corporate members with their voting power (based on purchases) matched by a strong and direct commercial interest in the success of CWS. Since the 2001 merger and the subsequent merger with United, it now has a structure where apart from the five directors from the Independent Societies, the remaining Group Board members, plus their Regional Board colleagues, are lay directors. This is not to undervalue the strong personal commitment of such directors to the Group itself, to co-operation more broadly, and to a linked set of political and social beliefs. It is simply to observe that this change in the composition of the Group Board has created a situation where – unlike Corporate directors (the chief executives of independent societies) – the majority of directors had no direct commercial or financial stake in the Group's economic performance other than the remuneration and expenses associated with their governance roles.[19] Yet the seven Regional Boards have accumulated, as the organisational legacy of their original corporate independence, a collective 78 percent share of the voting power in the Group (calculated on the basis of purchases by Individual Members).

**3.10** As described earlier, in practice it takes years to be elected to a Regional Board and individual tenures are typically long. The proclaimed justification for this has been that it forms a deliberate measure of predator protection against single-issue activists or carpetbaggers seeking to demutualise the Group.[20] Nevertheless, the practical impact has been that the primary source of power within the Group is firmly entrenched at the level of the Regional Boards and is supported by the practice of "concurrency", i.e. Group Board directors remain members of their Regional Boards and their own Group role is dependent on them being regularly re-elected to their Regional (and Area) seats. The pressure on Group Board directors to act as delegates for their Regions, rather than as independent representatives, is correspondingly intense.

**3.11** The further crucial manifestation of Regional dominance is that the practice of block-voting[21] gives various coalitions of Regions the power to prevent any proposed governance reforms, all of which constitutionally require a minimum two-thirds voting majority. Since the Regional Boards are not directly elected by members and, moreover, have no direct fiduciary accountability for the strategy and performance of the Group and the jobs of its 90,000 employees, this is a governance structure that has resulted in a considerable concentration of power without responsibility.

**3.12** This is one of the core systemic weaknesses in the Group's current governance that the present Review is addressing. A more detailed analysis is set out in Chapter 4.

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19 Plus their salaries in the case of elected employee members.
20 Since the abortive takeover attempt by Andrew Regan in 1997. See Wilson op cit. (p325).
21 Block voting is the legacy of corporate ownership where voting rights in CWS were proportional to corporate purchases by individual retail societies.

**3.13** To provide further context on the challenges of governance reform within the Group and the Co-operative Movement more generally, it is however important to examine first the previous major reform initiatives that have been undertaken over the last 60 years.

## The Co-operative Movement: Governance and reform since the 1950s

**3.14** At the outset of the 1950s, the Co-operative Movement appeared to have an unassailable position in the UK consumer market, above all in food retailing, where it held a market share of some 20 percent. It seemed to be holding its own against the multiple retailers, who held a roughly similar share of food retailing (23 to 25 percent), which had not changed much in 20 years.[22] Superficially, the Movement looked in good health. It had annual sales of nearly £1 billion, equivalent, adjusted for inflation, to sales of £20 billion (in £2014). It had a membership of 12 million; it owned over 30,000 shops, 250 factories, and the largest wholesaling organisation in the country.[23] It was pioneering the introduction of self-service, and leading the retail trade in the development of supermarkets. Yet it was already past the peak of its market power. Within a few years, it had suffered a severe loss of market share across many of its major areas of activity while its financial position, once felt to be impregnable thanks to the deposit savings of its huge membership base, had come under increasing pressure and was restricting the Movement's ability to invest for growth. The number of individual retail co-operatives – around 1,000 in 1950 – began a process of rapid decline, as smaller societies became uneconomic. A spate of mergers led to progressive consolidation into just 42 remaining societies by 2002. In parallel, the Movement's share of food retailing also experienced persistent decline, falling to around 4.4 percent by 2000 (see Exhibits 10 and 11 below).

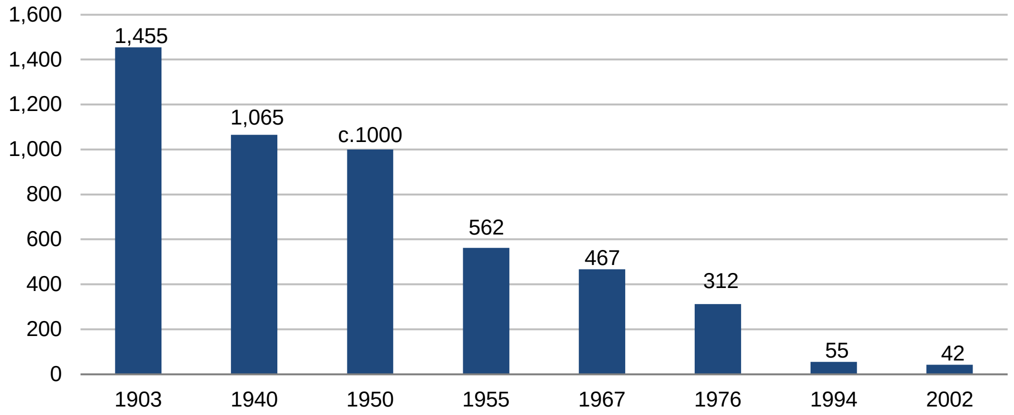
**3.15** How could a Movement that had such an apparently strong market position lose ground so heavily over the next 60 years? What role did the collective governance of the Movement, and of the individual major constituent organisations within it, play in contributing to this outcome? This is not just a question of historical interest, though it has of course been the focus of intense academic investigation. Analysing the causes has a direct relevance even today: we can study the determined efforts made by perceptive modernisers to halt this decline in market share and we can consider, in retrospect, why so many of their proposed reforms were thwarted by traditionalists or delayed until they were too late to make a difference.

## Internal reform efforts: The CIC Report of 1958

**3.16** Since the 1950s two major comprehensive attempts have been undertaken to reform governance within the Co-operative Movement.[24] The first was the Co-operative Independent Commission ("CIC"), which was established under the chairmanship of Hugh Gaitskell and which reported in 1958. The second was the Monks Report on the Co-operative Movement undertaken in 2001 following the merger of the CWS and CRS.

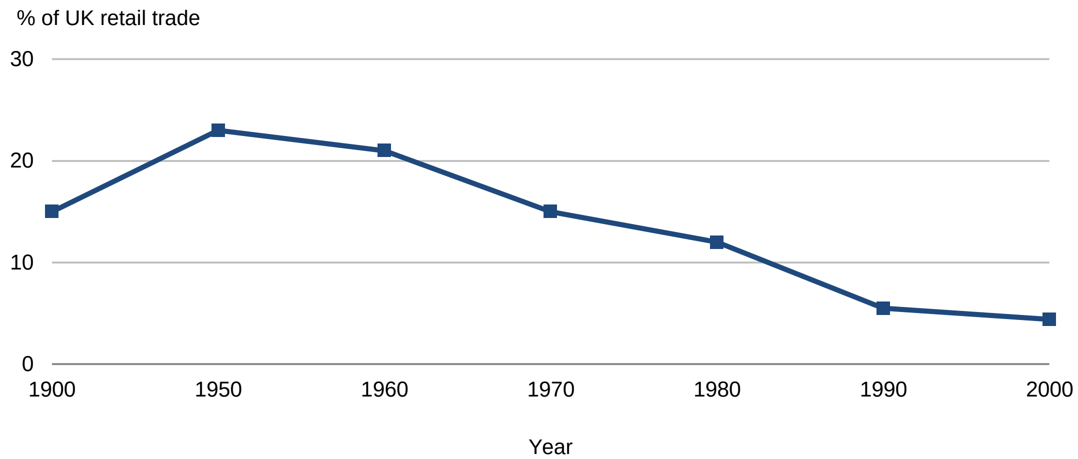
22 J. Jefferys Retail Trading in Britain 1850-1950. 1954.
23 Co-operative Independent Commission 1958 (p.1).
24 This excludes the internal constitutional reviews that followed the mergers of CWS and CRS in 2001, and of Co-operative Group (CWS) Limited and United in 2007.

## Exhibit 9 – Co-operative retail societies in the UK (1903-2002)



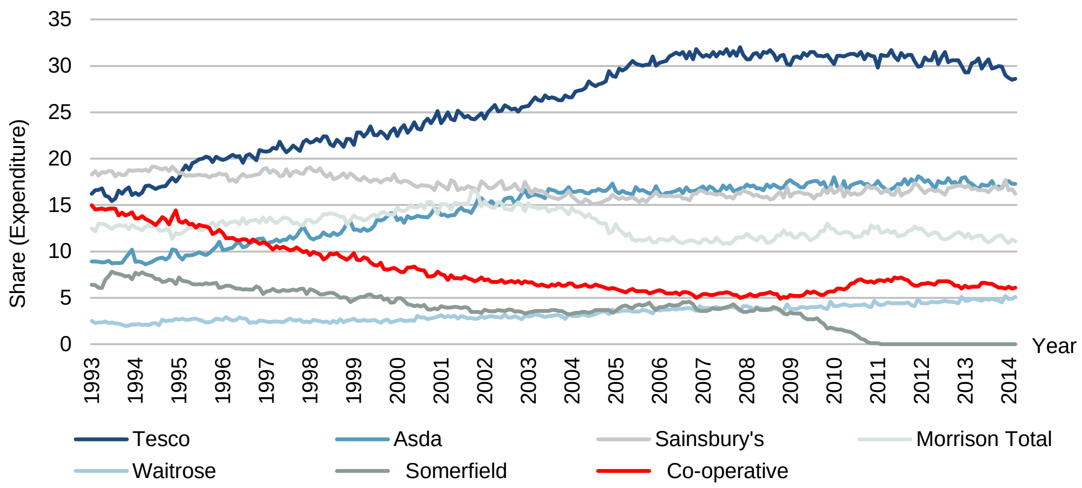

Source: John K. Walton the Post-War Decline of the British Retail Co-operative Movement (p.23) in Black and Robertson Consumerism and the Co-operative Movement in Modern British History, 2009

## Exhibit 10 – Co-operative societies' share of total UK retail trade 1900-2000 (%)




Source: Wilson, Webster & Vorberg-Rugh, Building Co-operation: A Business History of the Co-operative Group, 1863-2013 (Table 8.1, page 301)

## Exhibit 11 – Long term market share for UK food retailing




Source: Kantar Share of Till Grocers 2014

**3.17** The CIC Report delivered a penetrating assessment of the problems facing the Co-operative Movement. Its recommendations were prescient and in many respects have continued relevance today. In essence, the Commission highlighted two external factors that, taken together, posed a profound challenge to the Movement's economic viability.

**3.18** First, there was an urgent need for a fundamental response to the growth of multiple store chains that had gathered momentum in the US in the 1930s and had begun to make accelerating market share gains across Europe by the mid-1950s. This was not simply a question of converting counter-service stores to self-service – a process which the Movement had in fact taken the lead, with a 90 percent share of self-service stores in 1950. Nor was it just a question of building supermarkets, where again the Co-op collectively had a share of more than 60 percent in 1953. The driving force of this retail revolution was a radical change of the entire retail business model based on three principles: greater centralisation of core functions such as buying and marketing, greater supply chain integration, and rigorous standardisation of core operating processes and retail formats. As Anthony Crosland, the prime author of the CIC Report, detected, when coupled with centralised buying scale, all this posed a critical challenge to the loose, federal governance structure of the Co-operative Movement, with its hallowed commitment to local autonomy and "bottom up" democratic control.

**3.19** The second imperative was to come to terms with the rise of consumerism. From the early 1950s, this was transforming the shopping experience across all sectors of society, bringing a wealth of consumer choice and leading to fundamental changes in buying patterns as ownership of key items such as refrigerators, washing machines, cars and televisions became widespread. As The Economist editorial commented when the Report was launched, "*In one sense, the co-operatives have been left high and dry by the tide of social change. A movement created to serve the needs of a poor working class has failed to link itself with a prosperous working class*".[25] Crosland evidently disagreed with those (such as Richard Hoggart)[26] who saw consumerism as a trend to be both resisted and resented. Crosland insisted that the Co-op "*must give the customer what he thinks he wants as well as what it thinks he wants*".[27] As he put it in the Report, "*The slogan should be that nothing is too good for the Co-operator*". This was a perspective that had a mixed response across the Movement where a more paternalistic and puritanical view was often prevalent. Some indeed had already expressed severe reservations at the launch of ITV and the creation of a new advertising medium with its emphasis, as critics saw it, on invented wants rather than innate needs.

**3.20** The core recommendations of the CIC Report can be summarised as follows: (a) the urgent need to recruit more professional managers; (b) the imperative requirement for financial discipline and effective capital management; (c) the need to live by the laws of the market, with high service standards, competitive pricing, and rationalisation of an uneconomic network of retail societies and of manufacturing entities operating far below capacity; and (d) the creation of an innovative "retail development society" that would in various ways fill the gaps in the organisational capabilities of many small and medium-sized retail societies that were being starkly exposed by the growth of the multiple retail stores.

**3.21** These recommendations were based on a framework of principles – above all, the democratic principle on which the CIC Report made some important comments – that have continued relevance today. "*Naturally*", the report stated, "*the precise character of*

25 The Economist, 10 May 1958 (p. 517).
26 R. Hoggart, The Uses of Literacy, 1957 ("Progress is conceived as a seeking of material possessions…".).
27 Quoted in Lawrence Black, 'The Co-operative Independent Commission' in Black and Robertson, Consumerism and the Co-operative Movement in modern British history, 2009.

*Co-operative democracy has altered with the growth in the size of societies and other technical and economic changes. The degree of member-participation is now much less; and it is no longer feasible for the elected Board to undertake the detailed day-to-day management of a society*". Growing scale and complexity were already making the task of governance much harder. This was to be a recurring theme confronting individual co-operatives over the next 60 years and posing an increasingly difficult challenge to their Board capabilities.

**3.22** What was the reception of the CIC Report in 1958? To summarise briefly, there was a determined and largely successful attempt to kick its recommendations into the long grass. Despite Gaitskell urging "*don't defer and defer and defer*", as Lawrence Black puts it: "*central indifference and local autonomy triumphed*".[28] This was notwithstanding some trenchant external criticism. The Economist, for example, bluntly stated, "*This is a radical report aimed at a stuffy, conservative organisation which has fallen badly behind the times. After such a report, no movement could possibly sit back and do nothing*".[29]

**3.23** The central obstacle to reform was, predictably, the unwillingness of individual societies to surrender their autonomy, even when compelled to confront massive external challenges. Coupled with this, the forces for central co-ordination were divided in their respective goals and ambitions. These were the CWS, as the dominant wholesaler with potentially most to gain in commercial terms, and the separate political wing of the Movement, the Co-operative Union, which had keenly protected its own authority since its foundation in 1869. Both sought leadership to impose their views; neither was ready to concede much ground.

**3.24** In the face of commercial pressure that, however inexorable, was chronic rather than acute, the expedient political stance that ruffled fewest feathers was to reject Gaitskell's advice and to avoid short-term disruption while hastening long-term decline. And that was what happened, with a particularly notable hallmark being the widespread abandonment of the "divi" for customers by the end of the 1960s, further accelerated by the end of Retail Price Maintenance. The Commission had indeed warned of the long-term risk of over-distribution, and had argued for properly disciplined capital management to fund future growth. In the end, however, it was financial weakness, rather than financial prudence, that forced the decision.

**3.25** In light of the present financial challenges facing the Co-operative Group, it is worth noting the sheer scale of the lost opportunity that resulted from the Movement's inability to limit over-distribution and manage its capital prudently. The Independent Commission Report gives a particularly striking illustration of this.[30] It pointed out that the total annual dividend paid by retail societies at that time was well over £50 million, implying at a yield of 4 to 5 percent a hypothetical market value of £1,000 to £1,250 million for the Movement. Translating these figures into £2014 values, the Co-operative Movement in the mid-1950s was, on the Commission's estimates, distributing (on a very high pay-out of earnings) an annual dividend equivalent to £1 billion today.[31] On the same assumptions made by the Commission (i.e. assuming a price/earnings ratio of 20), the Movement had at that time – nearly 60 years ago – a hypothetical market value in the region of £20 billion in today's terms i.e. roughly twice the current combined value of Sainsbury's and Morrisons', and broadly comparable with Tesco's, market capitalisation. Even on a far more conservative price/sales valuation of, say £5 to 7 billion, this is nevertheless a measure, however uncomfortable, of the Movement's colossal failure of capital management and financial discipline over the subsequent decades.

28 Black and Robertson op. cit. (pp. 38-39).
29 The Economist op. cit. (p. 513).
30 CIC Report (p. 22).
31 House of Commons Library, Inflation: the value of the pound 1750-2011. Research Paper 12/31, 2012.

## *The Co-operative Commission of 2001 and internal reform efforts*

**3.26** The final recommendation in the CIC Report was that "*the Movement should formally re-examine both major constitutional issues, and also its basic trading policies, at least once every decade*".[32] However, it took over 40 years of continuous decline before another review of the Movement was undertaken, this time prompted by the merger of the CWS and the CRS to form the Co-operative Group. Unsurprisingly, the first line of the Report stated, "*A renaissance of the Co-operative Movement in the UK is long overdue*".[33]

**3.27** The Commission was chaired by John Monks, General Secretary of the TUC. The Report's thesis was straightforward: there was a Co-operative Advantage potentially within reach. This was defined as "*Excellent products or services with distinct competitive benefits derived from our values and principles, our rewards for members or our commitment to the communities we serve". More specifically, it argued for a "virtuous circle theory… suggest(ing) that attainment of social goals provides a competitive advantage leading to commercial success, which then reinforces the ability to meet the social goals*".[34]

**3.28** The Report produced 60 recommendations that covered commercial performance, membership participation, governance and change management, affiliations and social goals.

**3.29** The core of the Commission's analysis rested on its repeated insistence that, while co-operatives were more than businesses, their first priority was to create economic value; only then was it possible to distribute it. "*Commercial activities must generate a sufficient surplus to ensure the redevelopment of the business; the payment of individual customer economic benefits; and the payment of a community dividend. Without a surplus the business will decline and social goals will not be met.*"[35] In support of this assessment, the Report listed 17 main factors that, on the evidence collected, had led to the underperformance of a substantial section of the Co-operative Movement.[36] At least 10 of these were attributable to weaknesses at Board and senior executive level. And once again, as in 1958, the common underlying theme was a failure to grapple with the organisational demands of running a successful retail business in the face of intense market competition. There was, for example, inadequate strategic direction, unwillingness to take commercially necessary decisions such as closures of perennially loss-making activities, a lack of focus on commercial performance, and failure to keep pace with business sector competitors.

**3.30** While the Monks Commission Report received a more positive welcome than its 1958 predecessor, fundamental progress in certain critical areas of governance was limited. Following the CWS-CRS merger, the Group established a Rules and Practices Review Board (chaired by Lord Morris) to consult stakeholders and design a new governance structure.[37] In particular, the Co-operative Group's Rules and Practices Review Board did not adopt the general recommendation for large co-operatives that at least two executives, the Chief Executive and Financial Controller, sit on the board. Similarly, while the recommendation for new eligibility criteria for Board candidates was adopted following the 2007-2009 Constitutional Review that followed the merger with United Co-operatives, these encountered considerable resistance within the Group, since for a number of activist members this went against what they saw as a fundamental co-

32 CIC Report (p. 253).
33 The Co-operative Commission 2001 (p. 1).
34 The Co-operative Commission 2001 (p.18 and p. 84).
35 The Co-operative Commission 2001 (p.14).
36 The Co-operative Commission 2001 (pp.14-15).
37 For an overview of the governance architecture of the CWS and CRS before the merger, and the three-tier governance structure that was established following the Rules and Practices Review, see Appendix 6.

operative belief that anyone had the potential to be a board member and that director positions should be the outcome of democratic elections, regardless of relevant skills or expertise. A further aspect of this was, of course, that the electoral process made no provision for creating a team with a broad range of skills and experience since it was simply based on geographical constituencies. The compromise outcome was that the minimum qualification standards were set at a level that, by any objective measure, was unacceptably low.

**3.31** Notwithstanding this ongoing reluctance to put in place such widely accepted governance practices, the Co-operative Group appeared to be achieving a considerable renaissance in its fortunes in the first few years after the CWS-CRS merger. However, in governance terms this was a cruel, false dawn.

**3.32** The central, unresolved issue was how to address two deep-seated governance weaknesses that left the Group exposed and vulnerable to corporate empire-building and misconceived acquisitions: first, the inability of a Group Board substantially composed of lay directors to provide effective monitoring and guidance of the Executive leadership team (i.e. an acute form of the classic "agency problem" studied by economists), and a particularly dangerous weakness for any organisation that was becoming increasingly reliant on its fast-growing banking subsidiary; second, the need to overcome the serious problem of having the Group's governance controlled by a very small group of long-standing activist members who alone comprised the dangerously limited pool of candidates from which Group Board members had to be elected. That such a small minority out of a membership of several millions could exercise such disproportionate influence over the entire organisation's future is a prime example of the second major governance vulnerability identified by economists: the "*private benefits*" that accrue from entrenched incumbency.

**3.33** These two critical weaknesses in the Co-operative Group's governance structure are inextricably linked. That is why the case for radical reform is urgent. Before examining in more depth the implications of these governance weaknesses, it is, however, worth reviewing how large co-operative movements elsewhere in Europe have responded to the same set of challenges from multiple retailers and from changing consumer tastes and aspirations.

## Exhibit 12 – Two classic governance concerns

**The agency problem**

"Agency problem" refers to the potential for a conflict of interest between the management of an organisation and its owners. Management is expected to act in the best interests of its owners (in a co-operative, its members). However, the ongoing risk is that without effective governance in place, management will act with self-interest to maximise its own benefits. While it may not be possible to eliminate agency problems, it is often possible to achieve greater alignment of interest between managers and owners through, inter alia, the creation of a board of directors to provide monitoring, challenge and guidance, requirement to disclose material information to key stakeholders in a timely fashion and well-designed incentive schemes that link executive remuneration to clearly defined measures of corporate performance.

**The private benefits of control**

This is the governance term that describes the disproportionate economic advantages that may be secured by a subset of an organisation's owners at the expense of the rest. It often refers to the ability of voting blockholders to exercise undue influence over the direction of corporate decisions in favour of activities and projects that are uniquely or disproportionately beneficial to the blockholder compared with other owners. It can also refer to other forms of personal benefits, for example, generous expense allowances and other entitlements, that are available only to a restricted proportion of an organisation's owners as a direct accompaniment of the voting power that they control or position they occupy. The standard corporate governance arrangements to limit private benefits focus on three elements: (a) strict legal controls that limit the scope for expropriation of corporate earnings or assets; (b) voting reforms that restrict the abuse of blockholding; and (c) tight monitoring and increased transparency with regard to the scope and scale of blockholder benefits.

## *International comparisons of co-operative performance since 1950*

**3.34** The co-operative movement across Europe was confronted by two major challenges from the early 1950s: first, the growth of multiple retail chains that had originated in the United States and which posed a radical threat to the traditional disaggregated business models of independent stores and wholesalers that characterised much of the European retail scene; second, the rise of consumerism, with its transformation of customer choice, proliferation of advertising and promotion of "lifestyle" rather than utilitarian purchases.

**3.35** These two developments presented a particularly complex challenge for many European co-operatives because they simultaneously threatened to undermine their business model and also their governance framework. It is thus illuminating to compare the reform process in the UK with contrasting initiatives taken in other European markets with similarly strong co-operative movements that were facing similar external market pressures.

The key, if obvious, point to make is that a business model is not the same as an ownership model. A business model defines the particular formula of revenue generation and resource utilisation that will enable a commercial entity to create economic value in a particular market context. An ownership model, by contrast, identifies, in economic terms,[38] those who share two formal rights: the right to ultimate control of an enterprise, and the right to the organisation's residual earnings after it has made all payments to which it is contractually committed.[39] The significance of the distinction is this: the co-operative ownership model, notwithstanding the other benefits it confers, does not, by itself, generate any automatic competitive advantage over other ownership models irrespective of market context. It is the degree of adaptability to changing market contexts that remains key to competitive survival. And it was these changing market conditions that, from the 1950s onwards, were putting retail co-operative movements under pressure across Europe. To put it more generally, the advantages of co-operation as an ownership model are not a given; they are highly dependent on market context and, even then, they have to be earned and sustained through superior value creation in day-to-day operations and that, in turn, depends on developing a competitively superior business model that is keenly attuned to the changing needs of members, and indeed other customers.

**3.36** The challenge posed by the growth of the multiple retailer business model was that its competitive advantage lay in economies of scale achieved through three critical components: centralisation of core functions; supply chain integration; and detailed standardisation of operating processes and retail formats. Yet these characteristics were hard to reconcile with the traditional values of local autonomy that were typically such prized features of the co-operative ownership model.

**3.37** The result was a governance challenge: how to maintain the virtues of co-operative ownership, including its personal and collective social dimension, with the economic advantages of a business model that demanded tightly centralised control.

**3.38** In practice, the organisational response by consumer co-operatives across Europe has fallen into three categories:

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38 The co-operative ownership model clearly has other important social dimensions.

39 Henry Hansmann, The Ownership of Enterprise, 1996. See Appendix 3 for a full discussion.

- Federation of co-operatives. This exists where individual consumer co-operatives each retain a high measure of autonomy but where they also purchase a substantial (if not total) amount of their supplies from a wholesale co-operative which they jointly own. This is the model found, for example, in Norway, Finland (SOK) and Italy

- Integrated co-operative. This is the structure where a substantial degree of vertical integration is achieved between wholesale and retail outlets, and where the constitutional arrangements balance the governance requirements for top-down co-ordination of policies, strategy, branding, pricing and other matters with the requirements for bottom-up elected member participation in the oversight of the entire entity through a geographically represented general assembly with, typically, representation on the supervisory board of the entire group. This is the model found, for example, at Migros in Switzerland

- Hybrid form. This is the structure where a wholesale co-operative business owns and supplies its own retail outlets but also supplies independent co-operative societies (though not necessarily as an exclusive supplier), and where the independent consumer co-operatives retain an ownership share in the wholesale co-operative. This is the model found in the UK and also in Denmark and Sweden

**3.39** What insights can we glean from examining the comparative success of these different organisational responses to a common threat? The natural expectation might be that the integrated co-operative model had a decisive advantage because of its similarity with the investor-owned, multiple retailer model. In fact, however, the empirical evidence reveals a much more complex picture. While Migros, for example, has been successful in Switzerland, integrated models have failed in Germany and Austria. Equally, while federal models have had relative success in Finland (SOK), Norway and Italy, they have failed in France and Belgium. As for the hybrid model, Denmark and Sweden offer evidence of some success, while that model has failed in the Netherlands.[40] The future outcome for the Co-operative Group in the UK still, of course, remains highly dependent on achieving the appropriate mix of strategic renewal and fundamental governance reform.

**3.40** What, if any, are the common features behind these outcomes?

**3.41** The first point to make is that co-operative retail models have generally struggled when they have had to compete over long periods with strongly established multiple retail chains. The co-operatives that have performed well have typically been those that commanded from an early stage a substantial, if not dominant, position in their local retail markets, as is the case for example with Migros in Switzerland and SOK in Finland.

**3.42** A second factor is that all of these co-operative models have had to work hard on competing with the integrated supply chains of the multiple retailers in a way that is compatible with the values of co-operation and local autonomy in particular. Negotiations over supply chain co-ordination have frequently been protracted and even acrimonious. The most effective outcomes have been achieved where, as in the federal structure in Norway, a clean but collaborative division of responsibilities was secured between the retail societies and a single integrated wholesaling operation. According to one investigator, for example, much of this boils down to a matter of emphasis within the Co-operative Movement – whereas "*the British view tended to focus on the value of local independence, self-governance and the obligation to serve local communities, the*

[40] E. Ekberg Organisation: Top Down or Bottom Up? The Organisational Development of Consumer Co-operatives, 1950-2000 (p. 237) in P. Battilani and H.G. Schroter, The Co-operative Business Movement, 1950 to the Present, 2012.

*Norwegian co-operators primarily focused on the task of rationalising the system of distribution*".[41]

**3.43** A third common feature determining differential outcomes has been the crucial importance of effective capital management. Co-operatives have no access to primary equity; they therefore need to operate with conservative balance sheets. But to survive and flourish, they also need to grow. As the growth of co-operatives is critically reliant on generating retained earnings, sustained strong operating performance is crucial. Yet this in turn requires the constant upgrading of stores and heavy investment in matching competitor initiatives. This calls for exceptionally disciplined management and board leadership that puts core competitive strength in trading performance as the fundamental ongoing priority. Such a stance is, however, difficult to maintain in the face of competing and constant pressures on elected board members to offer benefits to members or to distribute funds to favoured affiliated bodies and community causes. Both of these have traditionally been an important dimension of "co-operation", at least as understood in the realm of large consumer co-operatives. But the price has been high. For example, according to one academic analysis, instead of strengthening its financial position, in the period from 1945 to 1985, the share capital of the UK Co-operative Movement declined by 95 percent in real terms over that period.[42]

**3.44** Not surprisingly, there has been a significant failure rate of consumer co-operatives, with the retail movement encountering severe setbacks in Germany, Austria, France, Belgium and the Netherlands.[43] In today's competitive retail markets across Europe (which are very different from the inefficient, monopolistic and exploitative markets in which many co-operative movements originally flourished), it is increasingly difficult to sustain economically successful large-scale consumer co-operatives without having outstanding operating performance and a sustained ability to invest capital for future growth. The evidence indicates that this can be achieved under various governance models where there is a relentless emphasis on the practical needs of the operating model (e.g. centralised distribution). The evidence also strongly suggests that since the 1950s some retail co-operative movements have largely failed when their governance has become unduly ideological and partisan, while they have performed better in social and cultural environments where their appeal has not been confined to particular socio-economic groups.

## *Implications for reform*

**3.45** Setting the current governance issues facing the Group in the broader context of earlier reform initiatives and international comparisons highlights clear themes that will be explored in greater detail in the following sections and will inform the recommendations of this Report.

**3.46** There are four findings of particular significance:

– **The present allocation of governance powers to the Regional Boards is severely dysfunctional.** It has become a huge impediment to effective governance, whatever its historical usefulness in facilitating mergers with other societies, and, as a separate matter, provides a degree of predator protection against demutualisation. The core governance problem of the Regional Boards is "power without responsibility". This is not just a matter of the block votes that

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41 E. Ekberg Consumer Co-operation and the transformation of modern food retailing in Black and Roberston op. cit. (p. 63).

42 P. Paxton, Consumer co-operative capital, Yearbook of Co-operative Enterprise 1989 (pp. 67-71), cited by E. Ekberg in Black and Robertson, op. cit. (p. 55).

43 P. Kramper, Why Co-operatives Fail in Battilani and Schroter op. cit. (p. 132).

the Regions each wield; it is also because of so-called "concurrency", the requirement that Group Board members must simultaneously be members of their Regional Boards and Area Committees. This subjects Group Board members to the pressure of annual re-selection by individuals who in many cases have no experience in, and no particular appetite for, making commercial decisions. Group Board directors are thus torn between their need to act in the interests of the Society as a whole, and the strong, insistent pressure not to get out of line with their Regional Board. Under such tension (discussed in more detail later), communication between the Executive and elected members do not work effectively, with difficult messages suppressed because they are unpalatable for Group Board directors to share. Equally, slow decision-making and deliberate procrastination are almost inevitable

– **The Review's second finding is the need for a strong, ongoing commitment to value creation.** There is nothing in this that is inconsistent with co-operation. Co-operatives are "for profit" organisations, established for the benefit of their members. The two major governance reform efforts of the last 60 years were inspired by deep insights on this need for value creation, given the serious nature of the competitive threats facing the UK Co-operative Movement. The reports produced powerful recommendations. However, on each occasion clear warnings to the Movement were ignored. There was a serious failure to take a long-term strategic perspective and put in place effective risk management. For the Co-operative Group, the result in recent years has been unsustainable empire-building at a colossal cost to the Group's equity and, correspondingly, its ability to fund future growth

– **International comparisons show that large retail co-operative movements have no automatic right to survive.** This is the Review's third finding and it shows that there is no case for complacency. The potential competitive advantage of the co-operative ownership model only works if it is highly attuned to the particular market contexts in which it is operating, and if it is then combined with a competitively superior business model.[44] Where this is not the case, the price of co-operation can simply become too high. The stark evidence of this is the failure of a number of once-substantial retail co-operative movements across Europe. Where, by contrast, retail co-operatives have flourished, the evidence suggests that this is not because of the adoption of a single "winning" governance model. Instead, it has been the outcome of painstaking efforts within individual markets to design co-operative business models that can match the efficiencies of investor-owned multiple retailers by achieving the mix of local autonomy and centralised co-ordination that is right for a particular country and socio-economic environment. The one common hallmark of such success, whether in federal or integrated ownership models, is the achievement of a notably high level of mutual trust between individual retail operating units and the central co-ordinating body[45]

– **Financial discipline is paramount.** Within the UK Co-operative Movement, the scale of value destruction, under-investment and over-distribution has been massive over the last 60 years. Essential performance measures have not been rigorously applied. Unacceptable risks have been taken. Continued success requires extreme care in capital management, and avoiding the irresponsible use of debt because co-operatives do not have access to primary equity and depend critically on retained earnings. The two major governance reform efforts of the

[44] For further discussion of this point, see Appendix 3.

[45] For example, see Friberg, Vorberg-Rugh, Webster and Wilson. The Politics of Commercial Dynamics in Battilani & Schroter op. cit. (p 250-255), or Ekberg op. cit. (p. 222).

last 60 years recognised this need for financial discipline. Indeed, the adoption of proper return on capital measures was a particular recommendation of the CIC Report. The new Executive team is now engaged in actively dealing with the consequences of reckless expansion undertaken by former management in recent years which has left the Group excessively exposed to the capital market pressure of bondholders and the banks. While the Group has in the past been the buyer of last resort for smaller, failing co-operatives, it has no bail-out option for itself

**Exhibit 13 – The need for financial discipline – a long-standing concern**

"We recommend that detailed investment decisions should be taken on the basis of a comparison of relative rates of return on capital. This concept appears to have been somewhat neglected in the past; and decisions have been taken under the influence of a variety of motives and pressures. The result has been a somewhat haphazard and perhaps wasteful use of Co-operative capital. Only if the criterion of return on capital is strictly applied will investment decisions be rational and capital efficiently employed".

Source: Co-operative Independent Commission Report 1958 (p. 245)

**3.47** In this section of the Review, we have examined the historical context for the Group's current dysfunctional governance structure. We have also briefly reviewed key findings from the two major governance commissions on the UK Co-operative Movement undertaken since the 1950s. Furthermore, we have summarised the experience of European retail consumer co-operatives that faced similar challenges over this period. We have not engaged in a detailed comparison with the performance of other ownership models of UK retail businesses over the same period. Nevertheless, a brief snapshot summary of the comparative experience of the Co-operative Movement, The John Lewis Partnership and Sainsbury's plc since their foundation within six years of each other in the 1860s offers some points for reflection.

**Exhibit 14 – Ownership structure is not enough – success depends on adapting to changing market conditions**

The Co-operative Wholesale Society was formed in 1863

John Lewis was founded in 1864 as a family firm, now a trust for employees

Sainsbury's was founded in 1869 as a family firm, now a plc

In 1950, the Co-operative Movement's share of grocery sales was 21.3 percent

In 1950, the aggregate share of multiple food retailers was 23 to 25 percent

In March 2014, respective grocery market shares were:

- The Co-operative Movement (total) 6.1 percent
- Waitrose 5.0 percent
- Sainsbury's 17.0 percent
- Four largest food retailers in aggregate: c. 75.0 percent

Source: Kantar (for 2014)

**3.48** Against this background, we now turn to the more detailed examination of specific weaknesses in the current governance of the Group.

# Chapter 4: Weaknesses of the Group's governance model

## *Introduction*

**4.1** The evidence set out in this chapter is designed primarily to illustrate the very broad range of governance weaknesses from which the Group currently suffers, and in so doing to underline how fundamental is the need for change. The accumulated evidence has not been set out to denigrate the commitment of individuals who have devoted and continue to devote their time and effort to serving as elected members. The Review team appreciate that active and elected members at all levels of the organisation are overwhelmingly well-meaning and hard-working individuals devoted to the ideals of co-operation and desiring to contribute to a successful TCG.

**4.2** In this chapter it has been necessary however to point to evidence that will rightly be seen as critical of both current and former elected members. This is painful but necessary as it represents the best way to help the Group and its broad membership to engage in a meaningful debate. It would not serve the Group's future path to recovery were this independent Review to gloss over or hide the governance deficiencies that it has identified. Any programme of governance reform must build on a strong foundation of accurate diagnosis, however painful the findings. The task of this chapter is therefore to set out the evidence found in an objective manner and in so doing to set the necessary context and rationale for the reforms that this Report is recommending.

**4.3** The evidence presented should serve as a stark demonstration of this Report's primary assertions – that TCG's governance framework is fundamentally and systemically flawed; that it has brought substantial harm to the Group and seriously damaged its competitive position; and that it inevitably positions the Group and its elected members for failure.

**4.4** While it would be wrong to ignore the clear failings of current and former elected members, the more fundamental issue is that the governance framework in which they have operated makes success all but impossible. The Group's failings cannot simply be laid at the door of those elected members who, whether through negligence, self-interest or a lack of commercial capability, have failed in their duties of responsibility and oversight. Those members' failings are a symptom of deeper weaknesses in the governance framework.

**4.5** Prior to this Review, the current Board has been composed of 15 lay directors and five Corporate directors from the Independent Societies. The lay directors do not possess the commercial experience to provide either the necessary oversight and effective monitoring of the Executive or the sought after strategic guidance or counsel. This Report has also concluded that the position of the Corporate directors on the Group Board is no longer appropriate.

**4.6** This judgement is not solely a reflection of lay directors' abilities or lack of experience. Were the current Board to be replaced with an entirely new group recruited from the same narrow pool of eligible Regional directors, the problems would remain because the current system does not generate a flow of appropriately skilled and experienced individuals. Blaming current or former individuals is simply not enough to reverse the Group's long decline. A Group of the scale and complexity of TCG cannot be governed by individuals who do not possess the level of experience required to sit on the Board of an organisation which needs to successfully compete in fast-moving, competitive business sectors. Asking them to fulfil this role will inevitably lead to catastrophic governance failures.

4.7 Rather than place elected members in positions that will at best leave them struggling to contribute in a meaningful way and, at worst, risk fundamentally harming the interests of TCG members, customers and colleagues, this Report's recommendations are designed to create a natural and fitting forum for individuals to devote their time and effort to the cause of co-operation. That is the central tenet behind the Report's recommendation in Chapter 5 for a National Membership Council, a far more effective way to harness the interests, energies and dedication of this group of individuals, and to give them genuine opportunities to shape the future of the Group.

This chapter seeks to clearly lay out the acute systemic weaknesses that it has found in the Group's governance framework. Those central weaknesses can be summarised as:

- **A manifestly dysfunctional Group Board**: The Group's structural deficiencies have affected all aspects of governance but this is seen most clearly in the ineffectiveness of the Board which has repeatedly shown its inability to direct and monitor a major commercial enterprise, operating in highly competitive markets.

- **A discredited electoral system**: The electoral system has consistently produced Group Board directors from the Regions who lack the necessary qualifications and experience to provide effective board leadership and to monitor, challenge and provide guidance to management. It has created divided loyalties among Group Board directors, entrenched a small, unrepresentative group in positions of power and significantly raised the cost of decision-making.

- **A disempowered membership base**: At the same time, there is a huge "democratic deficit". Ordinary members have weak constitutional rights and limited ability to steer TCG's social goals and activities to reflect their interests and values. Moreover, the Group's social agenda is insufficiently aligned and connected with the achievement of its strategic and commercial objectives.

**Exhibit 15 – Why a well-functioning board is critical**

The importance of the board of directors is increasingly recognised around the world and in different types of commercial organisations, including investor-owned companies, state-owned enterprises, family firms, and mutuals. Over the past couple of decades, considerable efforts have been exerted to improve the functioning of boards.

The key task of the board is not, as believed by some on the Group Board and in the wider Co-operative Movement, to "control" management. Rather, a good board plays a multiplicity of leadership roles – some highly visible but others quite subtle – from setting strategic direction to overseeing risk management to providing challenge, guidance and support to management.

For chief executives, one of the most valuable – and valued – roles that a board can play is to provide counsel and mentorship. Responsibility for leading a large organisation is, in fact, a lonely job and chief executives often have few people to turn to for candid and thoughtful advice. This suggests not only that the board must possess the experience, perspective and wisdom that would be useful to the chief executive but that the relationship between them needs to be underpinned by trust and mutual respect.

In co-operatives, an effective board is even more critical because in certain respects the law relating to co-operatives has been slower to develop compared with that applicable to companies. For example, provisions dealing with company voluntary arrangements and administration, director disqualifications and certain powers of investigation have only recently been extended to co-operatives. Moreover, external market discipline in the form of financial analyst and investor scrutiny is generally unavailable. Lastly, with limited means to raise equity capital, it is much harder for a co-operative to recover from a sudden depletion of reserves.

For TCG, a first class board is even more important given the Group's scale and complexity and the urgent need to be guided out of its current financial, organisational and competitive predicament. The Group competes against the very best in the private sector and has a diverse set of businesses with no parallel among the largest UK listed companies. Its financial circumstances mean there is little or no margin for error and TCG cannot afford any further strategic mistakes or major operational slip-ups.

## *A manifestly dysfunctional Group Board*

The Group Board's failings are multi-dimensional and can be summarised under four primary headings[46]:

- Inadequate collective capabilities and experience to fulfil its role
- Failure to understand their governance role
- Lack of unified perspective and shared purpose
- Excessively complicated structures

**4.8** *Inadequate collective capabilities and experience to fulfil its role*: Directors elected from the Regions (so-called "lay" directors) who serve on the Group Board do not possess the skills, experience and perspectives that are critical to effective stewardship of the Group and are unable to function effectively in dealing with the complex business challenges that TCG faces.

- For a board to lead effectively its members must collectively possess the mix of skills, experience and perspectives that are relevant to the organisation's needs and the demands of its business model. Group Board members are commendably attuned to and knowledgeable about ethical issues and have helpfully pressed management to conduct business in ways that are aligned with co-operative values and principles. However, with the exception of Corporate directors, the overwhelming majority of Board members have no fundamental commercial competence. There has been a recurrent tendency in boardroom debate to pursue social and ethical agendas without regard to relevant business context and realities.

- While Corporate directors bring business experience and skills and are familiar with commercial analyses and capital management processes, their capabilities are able to compensate only in part because the businesses that they run are substantially smaller than the Group's. Moreover, as the Kelly Review observes, "*many have worked only within the co-operative movement... All will have been conditioned, at least in part, by their long association with the co-operative way of doing things*".[47]

46 A full analysis of the Group Board, covering the areas listed in the Review's Terms of Reference and including supplemental recommendations can be found in the appendices.

47 Kelly Report, paragraph 14.14.

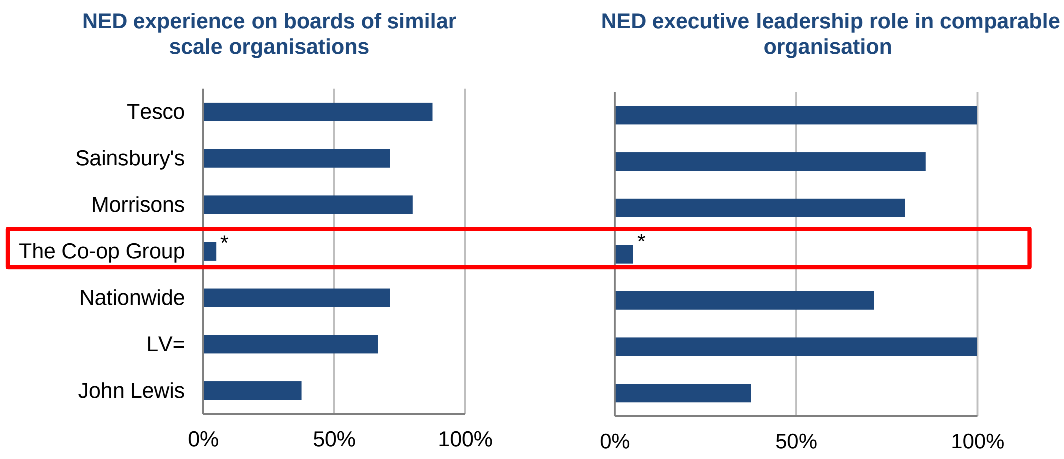
- The boards of TCG's major competitors typically have a mix of the following skill sets – finance, risk management, marketing, specialist retail knowledge, technology and communications, personnel and legal skills and property expertise. While the current Group Board does include members with general skills in some of these areas (e.g. accounting qualifications), their collective experience base is nowhere near the required level.

- While individual directors are expected to contribute in different ways and no single member of a board is likely to possess all the needed skills and experience, there is a set of threshold competencies that everyone on the board needs to possess to function effectively as individuals and as a group.

- The current lay directors lack most of the essential skills, experience and perspectives needed for an enterprise as large and diverse as TCG. The gap in average competence between the Group Board and its counterparts at large UK retailers and other businesses is stark.

- In fact, the collective skills and experience base of Group Board directors has progressively deteriorated in recent decades. A watershed moment was the constitutional change that followed the CWS-CRS merger in 2000, when lay directors – with generally weaker business experience than directors from independent societies – became a majority on the Group Board for the first time.

**Exhibit 16 – Peer comparison – NED experience**




* Paul Myners
Source: Peer websites as at 14 February 2014

The enormous gap between the current collective competence level and the required level means that training – typically the preferred method of bringing lay directors up to speed – will not compensate for the lack of direct, senior-level experience gained from working within large, complex organisations. It is naïve to argue that skills gaps can simply be closed by training programmes, no matter how comprehensive. In this light, the seemingly casual disregard for their individual short-comings among a few Group Board members is regrettable. As one Group Board director put it: "*In a democracy, if I am elected and not adequately trained, then is it my fault?*"

- The deficiencies of the Group Board described above have a number of significant ramifications, including an inability to understand the complex business issues presented to them and therefore to question the quality, robustness or completeness of the information with which they are provided. Many lay directors have described the information they receive as too complex and several expressed a desire for the Executive to produce short summaries, even for business and financial topics that are unavoidably highly complex.

- This deficiency severely hampers the quality of boardroom conversation. For example, in a recent review of an advertising campaign to reposition customers' perception of the food business, a discussion of the key success factors was interrupted by a question from a lay director about whether the price of a loaf of bread would be the same in all stores.

- Typically, the comments of lay directors on commercial matters are driven by personal anecdotes, in the genuine belief that they are making a valuable contribution by serving as the voice of the member/consumer. There is a failure to recognise that some such anecdotes provide inappropriately parochial perspectives. One Subsidiary Board IPNED commented that the contributions from elected members at a recent Subsidiary Board meeting were "*so poor and mundane that I felt sorry for the management team*".

- Lay directors' lack of understanding, combined with their inability to challenge the Executives, means that Group Board decision-making can be slow, cumbersome and of poor quality. These directors are not confident making assumptions and using their judgement to take decisions with less than complete data. This can be a severe handicap in fast moving commercial situations where board decisiveness is paramount.

- There is also a history of decisions being taken reluctantly (or not at all) and then, once taken, being reversed or ignored. Some Board members describe how a number of strategic decisions were only made with their "*backs against the wall*".

Against this backdrop, it is not difficult to understand how the Board pushed ahead with ill-considered acquisitions. They were either unable or unprepared to challenge the dominant view that the steps they were taking were the right ones. With each step the directors destroyed more value, took on more debt, increased financial risk and tarnished the Group's reputation.

### Exhibit 17 – Why compare the Group Board to large peers?

Some have questioned the rationale for comparing the Group Board to counterparts at large private sector competitors and mutuals. It is because large enterprises face a distinct operating and competitive environment, and Group Board members need to possess an intimate, executive-level understanding of this landscape in order to carry out their responsibilities.

The competencies that non-executive directors of large commercial enterprises, including TCG competitors, possess include the following:

- An understanding of how to lead, motivate and exercise influence in large and complex organisations
- An understanding of how things can go wrong in large organisations
- Experience dealing with complex operational processes (e.g. production, supply chain, distribution)
- Experience in high-stakes negotiations (e.g. supply contracts, credit agreements, joint ventures, acquisitions and disposals)
- An ability to make good decisions under intense pressure and with incomplete information
- An ability to quickly evaluate the strengths and weaknesses of a complicated commercial or strategic argument and understand their implications
- An ability to draw strategically and commercially relevant insights from disparate statistical data (e.g. changing customer demographics, industry trends, macro-economic data)

- An ability to ask incisive and insightful questions on complex topics that helps management move forward in their thinking
- Experience of engaging and influencing the media, regulators, and other external parties

## Exhibit 18 – The limits of training in developing the requisite competencies for the Group Board

A central tenet of the UK Co-operative Movement is that, with appropriate training, any individual can develop the competence to rise to the top of a co-operative. While this belief may hold true with respect to smaller co-operatives, training alone will not equip an otherwise inexperienced person with the skills required to serve effectively on the board of the Group, an enterprise of immense scale and complexity.

The reality is that the key competencies required for the Group Board to discharge its responsibilities – from working with management to set a coherent strategy for the Group's disparate set of businesses to monitoring and managing known and emerging risks arising from its complex operational and distribution processes – can be acquired only through direct, senior-level experience in comparably large and complex organisations.

It is extremely unfortunate that TCG members, particularly those who have devoted time and effort to fulfilling the various eligibility requirements for the Group Board, have been misled to believe that a series of very basic educational programmes would make them fit for Group Board roles. Even the world-renowned Harvard Business School would not make such a claim to its highly-capable MBA students.

In engaging with elected members over the past several months, the Review team has had to make clear to a number of individuals that the specified skills and any associated training that they had been told would qualify them for the Group Board were in fact far from sufficient.

It is notable that other businesses have typically not sought to appoint current or former elected members of the Group Board to their own commercial boards, a fact indicative of the wider lack of experience and competence on the Group Board.

**4.9** *Failure to understand their governance role*: Lay directors repeatedly blame management as almost entirely responsible for the Group's failures. With very few exceptions, lay directors do not admit to their own failings, including their consistent inability to exercise proper oversight of management.

- The board is ultimately accountable for an organisation's performance because it is responsible for hiring, monitoring, supporting and, where necessary, removing the management team. While a board may not automatically be to blame for specific management mistakes and misjudgements – particularly when executives engage in wrongdoing that is difficult to detect – recurring strategic errors or monitoring failures, as has been the case at TCG, place the board at fault. Yet, this obligation of accountability for its decisions and for Group performance is, in general, not accepted by TCG's lay directors. Instead, there is a pervasive "*victim mentality*", with directors routinely complaining of being patronised by Executives and of not being able to control them. This ties in with evidence found by this Review that "*under previous management, challenge was not encouraged"* and that *"the board is for rubber-stamping – always has been*".

- Such claims by lay directors that they have not been allowed or encouraged to challenge management teams are unacceptable and represent an abdication of those directors' responsibilities, as well as a thorough misunderstanding of how an effective board should operate. While a select few lay directors have expressed "*embarrassment*" and "*shame*" at management actions executed "*on their watch*" they have also described how they did not know how to stop them.

- Also disconcerting are admissions made by elected Group Board members with little understanding of financial issues that they have been content to rely on the "accountants" on the Board, even though none of these has had experience in an organisation of the size and complexity of TCG. Given the serious nature of the financial issues facing the Group – including matters relating to the recapitalisation of The Co-operative Bank – it is clear that each individual director needs to possess deep financial understanding to contribute effectively to difficult collective decisions, and to be held individually accountable. Several lay directors are clearly out of their depth when financial concepts and terminology are used or detailed performance or financial figures presented. They have therefore struggled to know the right questions to ask. While this presents some explanation for claims by certain directors that they were kept in the dark by past management on business matters, it also further underlines the calamitous impact of having board members with inadequate commercial capabilities.

- Attracting and keeping a strong management team that is focused on creating long-term value requires a capable board, one that is able to set strategic aims and boundaries, provide constructive challenge, review performance with rigour and thoroughness and provide support and mentoring. The Review has seen no evidence that the Group Board currently does any of these things effectively.

- At the root cause is the significant disparity in commercial knowledge and experience between lay directors and Executives. Almost inevitably, this generates intensifying frustration and mistrust on both sides, with Executives keen to respond rapidly to market developments and lay members wary of management's motives for seeking quick decisions. As one Corporate director commented, "*It is human nature if you don't understand something to be suspicious*".

- If the vacuum of guidance and support from the Group Board and the culture of tension and suspicion are not rectified, the Review believes that it will reduce the perceived attractiveness of TCG Executive roles for both the incumbents and any high-quality potential outside candidates. The long-term impact of such a trend in the Group should not be under-estimated. A failure to recruit top talent, or similarly allowing further departures of talented management from the Group, would severely impact the long-term standing of TCG.

**4.10** *Lack of unified perspective and shared purpose*: Lay directors all too often focus on the narrow interests of their constituencies and, correspondingly, display a lack of solidarity, misalignment of purpose and compromised collective responsibility with their fellow Board members.

- Under English law and repeated in TCG's Rules and Regulations, the primary and overriding duty of Group Board directors is to act in the best interest of the Society, having regard to the collective interests of its present and future members.[48] However, driven by an electoral system (discussed below) that fosters a parochial perspective and embeds conflicts of interest among its members, the Group Board displays scant collective responsibility.

- The Review has found limited shared purpose among Group Board directors. Among lay directors, some are predominantly interested in the Group's business activities but many are fixated with issues relating to their communities or focus heavily on single issues, such as Fair Trade or diversity. One TCG director told

[48] For a summary of the duties of directors of co-operative societies see Appendix 5.

the Review that "*some want a dividend, some want low prices, some want to do social good and some want free range chickens*".

- The Board also struggles to accept and demonstrate collective responsibility. During the period of the Review, one Group Board director appeared to have actively participated in a campaign to reverse a strategic decision made by the Group Board only days earlier, seemingly oblivious to the Group Board Code of Conduct requirement that directors "*support any decision of the Board, whether they agree with it or voted in favour of it*" and "*should stand by the decisions made by the collective Board*". The Review understands that lay directors have often found it easier, when reporting back to their Regional Boards, to distance themselves from endorsement of Group Board decisions (in many cases there is great doubt whether they have been able to properly explain the decisions they have taken, above all of complex topics such as the 2013 recapitalisation of the Bank).

- The electoral hierarchy slows down decision-making as lay Group Board directors claim that they need to get an opinion from their respective Region before condoning a course of action. This behaviour appears to fly in the face of the express provision in the Group Board Code of Conduct that "*Directors cannot be mandated by their nominating society or region or anybody else to vote in a particular way*". This is sometimes replicated at Area Committee level. Some decisions – such as the disposal of farms – have a high emotional element for Regional directors and their Regional constituencies and have historically resulted in repeated delays in taking action.

- There is an additional challenge in certain cases with regard to overlapping business activities between the Group and the independent co-operative societies. Given that the independent societies are highly reliant on the Group's buying power to remain price competitive this is an area of potential conflict. This means Corporate directors might, in principle, oppose any decision by the Group that would diminish the collective buying power of the Co-operative Retail Trading Group (e.g. if the Group were to exit a sector) or bring the Group into greater competition with their societies (e.g. through geographic expansion). This is clearly unsatisfactory and some lay directors expressed a lack of enthusiasm for having Corporate directors on the Group Board because they are viewed as competitors and, quite separately, because "*they are too close to the Executive to scrutinise properly*".

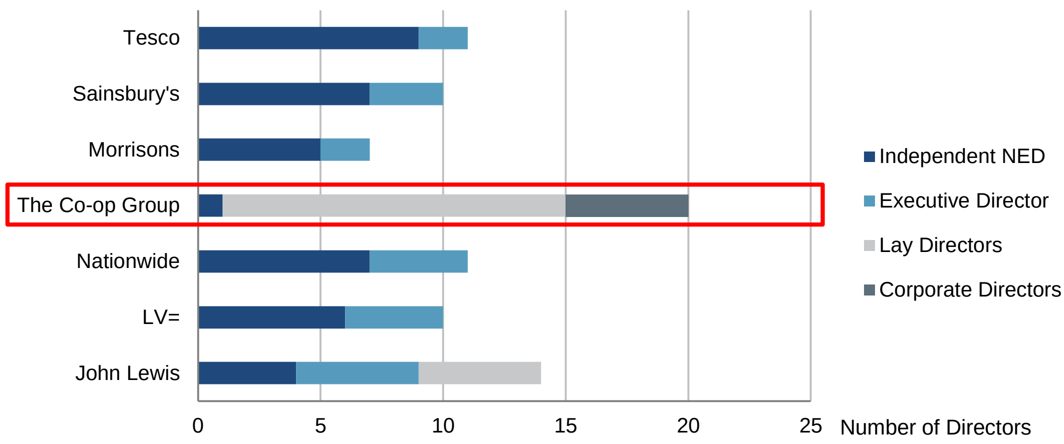
- The Board struggles because of these conflicts and an evident failure of understanding on the part of several directors, to act as a unitary body.

**4.11** *Excessively complicated structures*: Its large size and the gaps in accountability and other complications created by Subsidiary Boards have impeded the Group Board's effective functioning.

- Boards should be large enough to ensure that the skills and experience required by the business are present but not so large as to make board meetings unwieldy and diminish the ability of individual directors to contribute meaningfully. Various studies, including previous UK reviews of co-operative governance, have concluded that boards should ideally have no more than 8 to 12 members.

– With a membership of 21 the Group Board is too large.[49] Its size has undoubtedly harmed board functioning. In a 2012 survey carried out by an external facilitator, Group Board members themselves expressed the view that "*the large size of the Board could be adding to the challenge of effective debate and discussion*". IPNEDs on Subsidiary Boards commented that because of its large size, "*the share of voice*" of Individual Members is comparatively low and recommended that the size of the board be reduced to "*support healthy debate and discussion*".

**Exhibit 19 – Peer comparison – Board size and composition ***




* Excludes Company Secretaries
Source: Peer websites as at 14 February 2014

– Decision-making has clearly been held back by the Group Board's size and wide variations in director contributions. Board meetings typically feature bilateral exchanges between the director questioner and management respondent rather than a collective discussion where directors build on each other's contributions to deepen collective understanding and generate new insights. This, too, appears to be an enduring feature. A 2005 board evaluation noted that "*proper, constructive, interactive debate is almost impossible ... with successive speakers making unrelated points, observations or comments*".

– While it is acknowledged by some that Subsidiary Boards have improved board oversight of individual businesses, there are also complaints – including by some of their IPNED members – that Subsidiary Boards "*get in the way*" and create confusion about "*how the different accountabilities relate together*".

– This underlines a further problem, namely the lack of clearly defined responsibilities between the Group Board, Subsidiary Boards, the Values and Principles Board and various committees. To give one example, the recent decision on whether the Group should stock only Fair Trade bananas required the involvement of the Food Board, Group Board and Values and Principles Board, with unclear division of authority among them.

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[49] See Exhibit 19 for a comparison to TCG's peers. As noted in Chapter 2, one Regional seat on the Group Board is currently vacant.

## *A discredited electoral system*

**4.12** TCG's governance dysfunctions stem fundamentally from the design and operation of its electoral hierarchy, particularly the way Group Board members are chosen and the modes of interaction between the Group Board and intermediary bodies.

**4.13** TCG's three-tier electoral structure is an anomaly. Co-operative societies in the UK typically feature one or two-tier structures. A number of co-operatives – including Central England and Midcounties – have simplified their governance structures over the past decade.

**4.14** *Electoral processes*: TCG's electoral system is responsible for producing commercially crippling governance problems, particularly: (a) a Group Board with insufficient expertise to hold management to account; (b) Group Board directors pressurised to prioritise the narrow interests of their individual constituencies rather than the broader needs of the Group; and (c) domination by a small unrepresentative group who exercise disproportionate influence including "private benefits".

- The Group's bottom-up, competitive election process provides no rigour for assessing the commercial capability levels of candidates as there is no meaningful competency bar in place. Similarly, it provides no scope to balance the capabilities and fill skills gaps.

- The constituency-based election system has created a built-in "divided loyalty" problem. Both Regional and Corporate directors on the Group Board face pressures to prioritise the interests of their constituencies over those of the Group. The Review has been told that Regional Boards often regard their elected members as a delegate of the Region and as such direct them on what questions to ask and how to vote. The Review's observation is that many lay directors come to Group Board meetings wearing their Regional hats and conspicuously kept them on throughout the meeting.

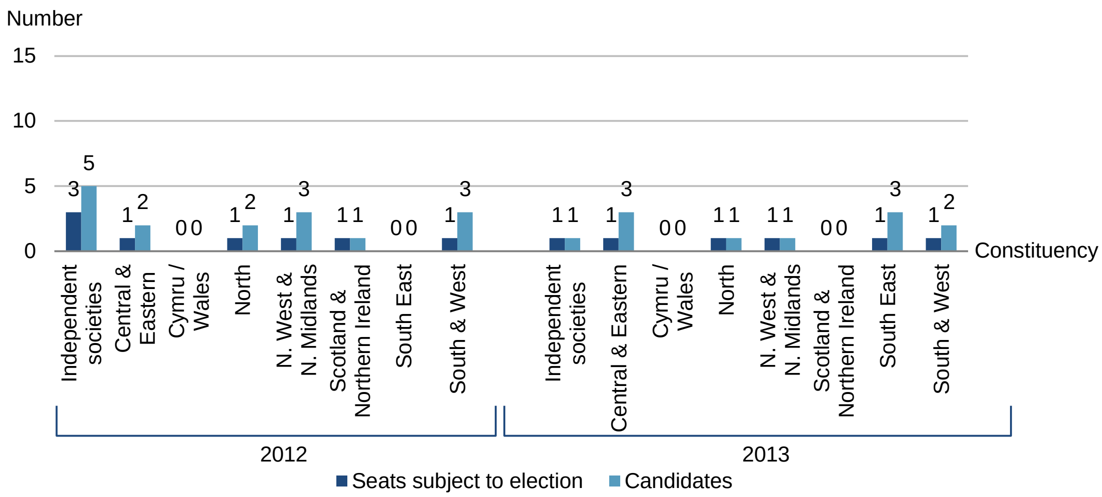
- In situations when a decision to be made serves the interest of the Group but not a Region's, elected Regional directors find themselves torn. Elected Regional directors can face re-election on an annual basis – whether to the Group Board, Regional Board or Area Committee – which can make long-term thinking in the interests of the Group challenging. As one insider said, "*Taking bad news back to the Regions when they need to be re-elected is hard*". Another said, "*There is a lot of pressure on the elected members to disown Group Board decisions and maintain that they were not in favour of them*".

- The requirement that a Group Board director must concurrently occupy seats at Regional Board and Area Committee levels also has damaging consequences. First, it severely restricts the pool of candidates eligible for election to the Group Board. Second, lay directors are under severe pressure to pursue short-termist attitudes because they face constant re-elections.

- A related concern is that the concurrent office and tiered tenure requirements have dissuaded individuals with "*skills but not time*" – particularly younger members – from seeking higher positions in the democratic hierarchy. Serving on the Group Board has become a nearly full-time occupation for Regional directors due to the sheer number of meetings they are required to attend at Group Board, Regional Board and Area Committee levels. Several Group Board directors have told the Review team that they have given up their "day jobs" in order to fulfil their expansive TCG duties.

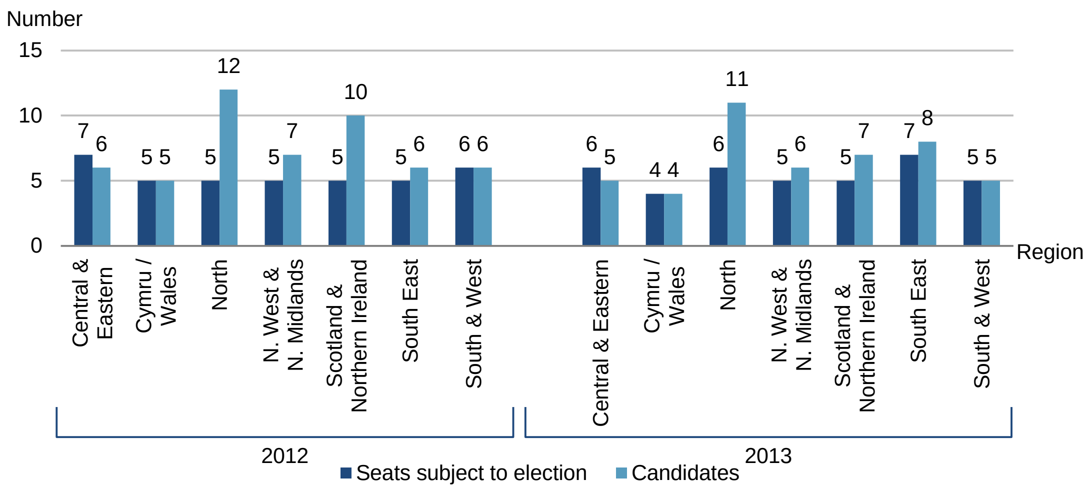
– The current electoral system also appears to stifle interest and participation, as it is not infrequent to see uncontested elections for Group Board and Regional Board seats (see Exhibits 20 and 21).

**Exhibit 20 – Contestability of Group Board elections 2012-2013**




Source: TCG Membership Team Feb 2014

**Exhibit 21 – Contestability of Regional Board elections 2012-2013**




Source: TCG Membership Team Feb 2014

**4.15** *Intermediary bodies*: The way that TCG's intermediary bodies operate has exacerbated the dysfunctions at Group Board level.

– Regional Boards have become dysfunctional not only because they exert pressures on Group Board members – through frequent demands for information and accountability – to prioritise constituency needs over those of the Group. They (and Area Committees) also create unnecessary interpersonal frictions because some of the information they request is confidential. There seems to be a clear lack of understanding at a Regional Board and Area Committee level of what the Group Board does and what information it can share. Elected Group Board directors have also been accused of using confidentiality as a convenient excuse rather than genuine reason not to share information. Lay directors have not been helped in managing this interface by a fairly consistent failure to agree how and when decisions can be communicated.

– A further concern, raised both within and outside TCG, is the extent of the value-adding contributions of Regional Boards, given that they are neither front-line and member-focused nor have formal responsibility for Group decision-making. Despite their not always having a full understanding of the circumstances surrounding Group Board decisions (particularly relating to commercially-sensitive matters) and not being accountable for Group performance, the influence they wield is substantial and constitutes a clear example of "power without responsibility".

– Indeed, Group Board and management members complain that Regional Boards find it easy and cost-free to criticise. One Group Board director said the Regional Boards are "*backseat drivers*" who "*nitpick because they don't have anything else to do*". Despite the formal role that Regional Boards have within the present constitutional structure, it is far from evident that they contribute materially to the effective performance of the Group's operations or that their governance role is adding value in other dimensions. This is a serious issue because interacting with the Regional Boards in a detailed manner and on a regular basis imposes substantial additional work on management. Concerns expressed by management include the ongoing disappointment that all too often Regional Board contributions are essentially anecdotal in nature and are more frequently concerned with finding faults than with trying to develop a deeper understanding of the core business issues.

– The Review found a number of examples of commercially inappropriate comments by Regional Boards directors. In one instance, a member of a Regional Board suggested that TCG "*put a bigger sign up outside*" a store to stem the decline in sales from the emergence of new competitors nearby.

– The value to the Group of the Regional Boards is frequently asserted, but there appears to have been no effort or appetite to objectively measure benefit against cost, including the cost of complexity and the disincentive effects of persistent, and sometimes hostile, second guessing.

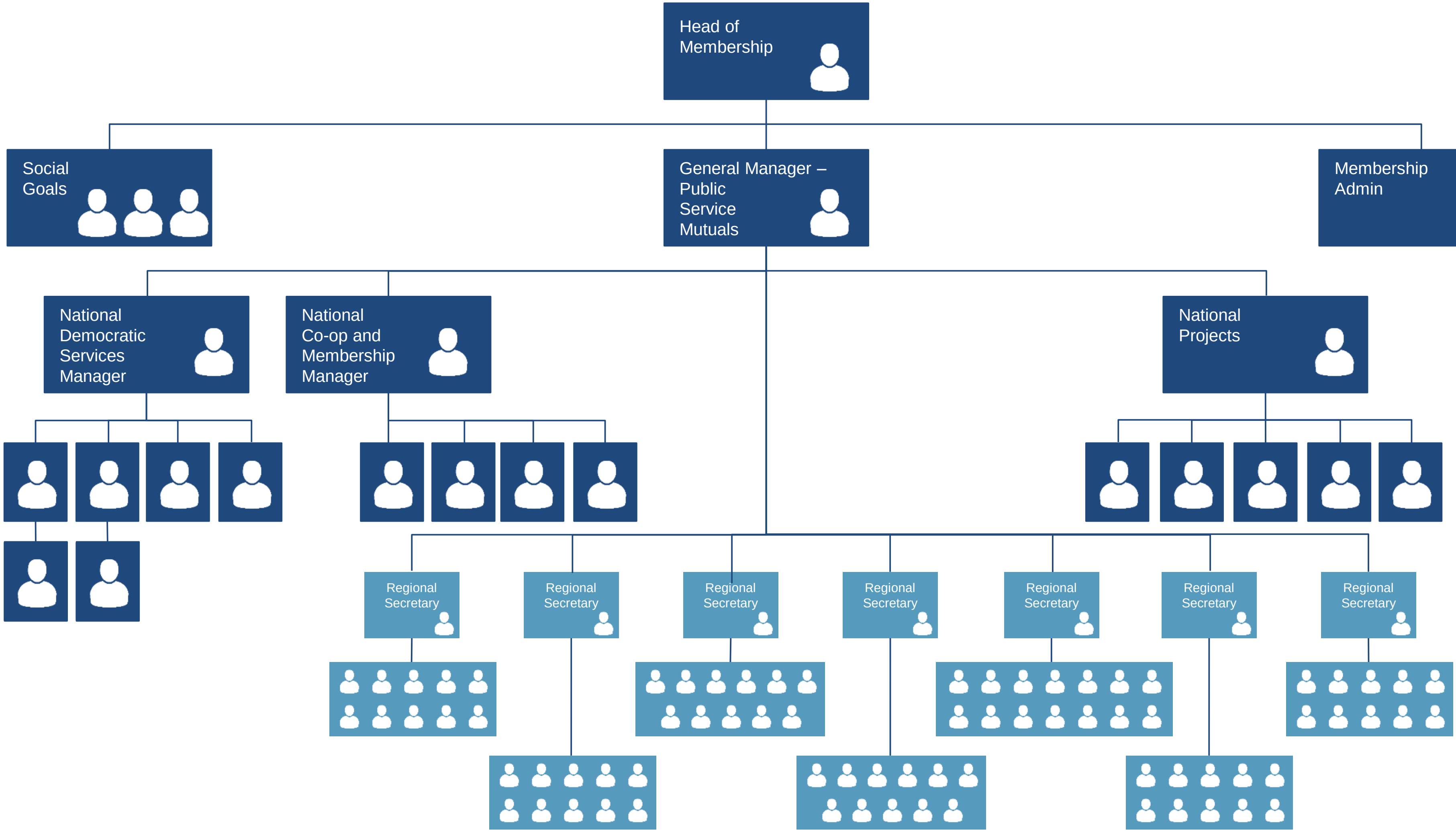
**4.16** *Supporting organisational infrastructure*: The infrastructure supporting the electoral hierarchy has also impeded the effective functioning of the Group's governance system.

– Presently, there is a strict separation between the Corporate Governance team supporting the Group Board and the Membership department supporting the Regional Boards, Area Committees and the wider membership. The demarcation of roles is highly inefficient. For example, the Review understands that it is not customary for the Group Secretary or Corporate Governance team to communicate directly with the Regional Boards and Area Committees, and vice versa. In addition, the Group Secretary has no direct reporting relationship with the Regional secretaries supporting the intermediary bodies.

– Separation of secretariat functions, combined with the lack of clarity on information that can be cascaded from the Group Board to Regional bodies, has caused Regional Board and Area Committee members to become frustrated that critical information – including reports relating to the weakened financial and competitive position of the Group – has not been communicated to them in a timely manner.

– The structure of the Membership team set out in Exhibit 22 is a further illustration of the complexity of the Group's governance structure. Aspects of the Membership team's current working practices contribute to the Group's difficulties in achieving appropriate, cost-effective connectivity with the entire membership base: First, there has been a tendency to foster a dysfunctional "meetings culture", with an evident willingness to convene meetings without sufficient regard to whether they are truly necessary or will have a meaningful impact. Second, the events organised or facilitated by the team, whether conferences or Regional Board meetings, are not always efficiently run and frequently involve costs, such as venue hire, that are hard to justify in terms of value.

## Exhibit 22 – Membership team structure




Source: TCG Membership team, October 2013

## Disempowered and neglected membership

**4.17** All of the governance weaknesses cited above have had the cumulative effect of creating a stark democratic deficit at TCG, with the voice and participation of the broad membership significantly stifled.

- To summarise, the current democratic system deprives ordinary members of important constitutional rights, including:
  - The ability to attend Society General Meetings
  - The ability to nominate and vote for Group Board members
  - The right to approve or reject major transactions
- In addition, the broad membership is poorly served by inadequate record-keeping and the limited means employed to understand their interests and convey the benefits of membership. Many members, for example, see their Co-op membership only as a loyalty scheme.
- It is apparent to the Review that the Group has not met the needs of the vast majority of the membership who are seeking good value and lower prices. In food retailing, for example, the Co-op is perceived by consumers to be poor on price and quality.[50]
- The social goals agenda is directed to the interests of a small cadre of active members, who enjoy disproportionate benefits (including authority to distribute substantial sums to social and other charitable causes).
- The current TCG membership infrastructure and activities serve this select group at a cost that is disproportionate to the benefits that the Group and broad membership receive. An audit to examine these matters in more depth is underway, and the Review has requested that a summary is produced for the membership.

## Conclusions: The systemic nature of the Group's governance weaknesses

**4.18** The purpose of this chapter has been to demonstrate that the significant governance problems now facing TCG are not simply the result of specific failures and individual shortcomings on the part of a handful of Board members and Executives over the last few years. Instead the dysfunction afflicting the governance system is structural and systemic. This means that incremental change will not suffice and that radical reform is imperative.

**4.19** At Group Board level, for example, the remedy is not simply to replace the current occupants in the boardroom because their successors – chosen under the present democratic system – will be subject to similar shortcomings and will continue to confront a dysfunctional operating environment. Nor is it to provide training and development for directors appointed under the current system as the gap between current capabilities and those needed is just too wide and some of the most critical skills can only be acquired through direct, senior-level experience.

50 Which? "The UK's Best and Worst Supermarkets", March 2014.

**4.20** A comprehensive overhaul of the entire democratic system is now required and one which recognises the failings of the current framework, the urgent work needed to correct the all-too evident democratic deficit and the risks facing the Group's long-term future without genuine reform.

# Chapter 5: Proposals for reform

## *Introduction*

**5.1** The governance challenges analysed in the previous chapter are substantial and far-reaching. For the Co-operative Group, the aim should now be to put in place an effective governance framework that can help ensure its continued viability as a commercial enterprise operating in highly competitive markets. Only then can the social goals and co-operative values that have been so central to its history and identity continue to be pursued.

**5.2** In line with previous governance reviews of the broader Co-operative Movement, this Review emphasises business success for a simple but crucial reason: Funds for social goals must – if the Group is to survive over the long term – necessarily come from trading surpluses, after sufficient capital has been set aside to sustain the business and fund future growth. In other words, value creation is the prerequisite for value distribution to members and to the furtherance of desired social goals.

**5.3** This is consistent with TCG's aim "*to be a commercially successful business*". At the same time, the Review fully recognises that TCG is a co-operative with a distinctive set of Values and Principles and in which members should have the opportunity to play an active and meaningful role in the Society's affairs.

**5.4** The Review is therefore proposing a reformed governance framework that is designed to achieve three objectives:

- First, a highly competent and qualified Group Board with non-executive directors who possess the skills and experience to exercise leadership and effective oversight of the Executive management charged with running a business of massive scale and complexity, quite unlike any other co-operative business in the UK

- Second, a new National Membership Council to ensure that genuine co-operative values and principles are protected and securely embedded in the future governance structure and the way TCG does business

- Third, the extension of democratic rights to all members to ensure that, as a member-controlled organisation, the interests of the entire membership are properly acknowledged and promoted and connectivity with members is enhanced

**5.5** The Review's recommendations correspondingly focus on these three areas:

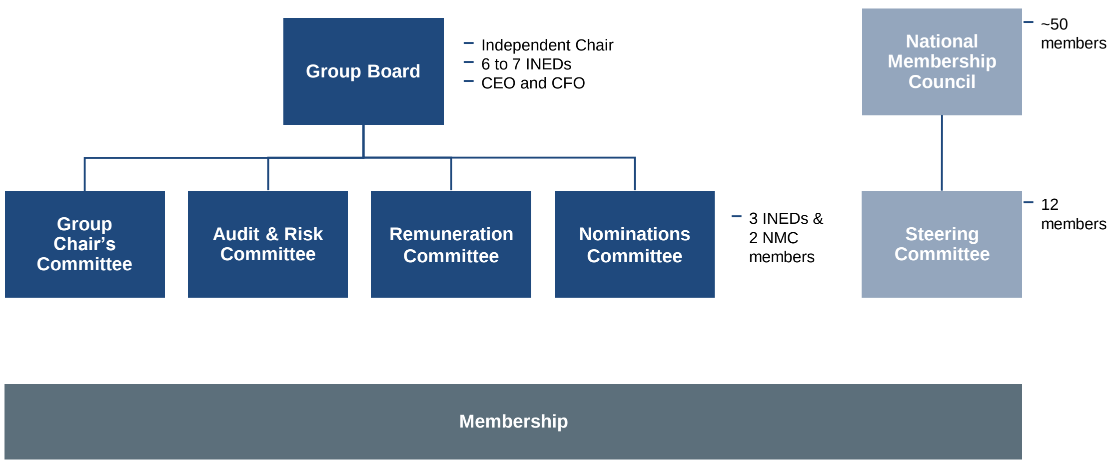
- A reformed Group Board

- A new National Membership Council

- Extended membership rights

A proposed plan for implementing these recommendations is outlined in Chapter 6.

## Exhibit 23 – Proposed governance structure




**5.6** The first pillar of the recommendations is the need to put in place the strongest possible Group Board. This is an imperative requirement to stem the Group's declining competitive position and to work with the Executive to help restore the Group's financial strength. Such a board needs collectively to possess the best available commercial expertise. In this critical situation, there is no room for passengers, or "token directors" on the Board of a group that is charged with spearheading corporate recovery, with meeting the needs of its members and its broader customer base, as well as looking after the interests of its 90,000 employees. This is the fundamental reason for proposing that the Group Board should comprise individuals who have the requisite skills and experience base to make a decisive contribution to the renewal of the Group and its future success.

**5.7** The second pillar is the creation of a new National Membership Council. The purpose of the Council, which is discussed in detail below, is to provide the best possible forum for those members who choose to become actively involved in governance activities, whether their interests are in the business operations of the Group, or, as in many cases, where their interests are predominantly in engaging on social and community issues where their enthusiasm and skill sets may naturally lie, and where they may be distinctively qualified to make effective contributions.

**5.8** Under the proposed structure, the Group Board would be responsible for all commercial matters and have full power and responsibility for management and operations. The National Membership Council would be a representative body tasked with guarding the Group's commitment to co-operative values and principles and acting as a consultative body to hold the Group Board rigorously to account.

**5.9** The third pillar is the extension of constitutional rights to all members. This requires in particular the extension of the one member, one vote principle, and related participation and approval rights, to be introduced in such a way that the legitimate democratic interests of the independent society corporate members are safeguarded.

**5.10** These core recommendations reflect a careful balancing of the considerations discussed above: the paramount need to ensure ongoing commercial viability and renewal, and the essential requirement to preserve the Values and Principles that have been a distinctive feature of the Group since its foundation. The proposals should correspondingly be considered as an integrated set of recommendations which dovetail into one another and cannot be considered and adopted piecemeal.

## A reformed Group Board

**5.11** Given the Group's financial and competitive predicament and the urgent need at this critical juncture for the best possible leadership, the Review has concluded that the most important governance reform is to put in place a fit for purpose Group Board.

**5.12** Owing to the structural nature of the Group Board's deficiencies, the Review has focused its guidance on the following:

- Board composition: skills, experience and size
- Board role and remit
- Nominations and appointment process
- Board evaluation
- Board policies and practices, performance metrics and company secretariat role

Supplementary recommendations on other areas falling within the Review's terms of reference are provided in the appendices.

**5.13** The need to put in place a well-structured and well-qualified board is urgent in order to address many of the governance deficiencies analysed in Chapter 4. These include:

- The inability of Group Board members to challenge management and hold them to account
- The tendency of Group Board members to focus on small details rather than on strategic issues
- The inability of the Group Board to take decisions quickly
- Tensions and mistrust between Group Board and management
- Short-termism and narrow interests of Group Board members
- A lack of collective responsibility on the Group Board

### Exhibit 24 – Professionalising the board

Over the past two decades, considerable efforts have been exerted across the globe to professionalise the boards of commercial organisations regardless of ownership structure.

Initially, reforms such as the 1992 Cadbury Report in the UK focused on structural changes to ensure adequate board independence, prevent excessive concentration of power and balance the work of the board.

In the UK, further reforms in the ensuing decade maintained the emphasis on structural issues. These included director remuneration, audit committees and strengthening independent representation on the board. At the same time, there was increasing realization of the need to improve board processes, resulting in guidance on, inter alia, internal controls, director appointments and board evaluation.

Board appointments, in particular, underwent a revolutionary change. Rather than filling vacancies through the personal networks of incumbent directors (particularly the chair's), a properly structured nominations committee was charged with drawing up the competencies required by the board and developing skills and expertise specifications each time a vacancy arose. The pool from which candidates were drawn widened considerably, including through the use of search consultants.

In recent years, emphasis has been placed on the "softer" aspects of board functioning, including effective decision-making, the chairman's leadership style, relationship between the board and management and flow of information to the board.

The continuous efforts to enhance board functioning and effectiveness mean today's boards differ markedly from those a generation ago: Improvements are clearly visible in such areas as individual director and collective board skill sets, the independence of board directors, the focus and quality of board deliberations and the processes to support the board's activities.

The implication for TCG is that it must equally strive to professionalise its board – analogous to the decision of co-operatives to professionalise management in the 1950s – in order to remain competitive with its private sector counterparts.

**5.14** Many members have conveyed to the Review team the importance of maintaining member control on the Group Board and underscored its essence to the identity of co-operatives. As described in more detail below, genuine democratic control will be secured in two ways: first, all non-executive directors will themselves be members committed to co-operative values and principles; second, all such directors will be subject to regular election and re-election by the entire membership.

### Recommendation 1: Board composition – skills, experience and size

- The Group Board should comprise 6 to 7 independent non-executive directors and two executive directors, led by an experienced and independent chairman
- The size of the Group Board should be capped at 10 members and independent NEDs should always constitute a majority over executives on the Group Board
- All appointments to the Group Board should be decided on the basis of objective criteria. Non-executive directors should have the skills and experience of their counterparts sitting on the boards of the Group's primary competitors
- Vacancies on the Group Board should be openly advertised, with specifications for individual positions clearly defined

**5.15** For the Group to be successful in the long run, it must be able to attract, develop and retain a strong and competent management team. This fundamentally requires a highly competent and experienced board – one that can keep up with the executives, earn their respect and has the ability to provide constructive challenge, steering and mentorship. A strong board is also essential to limit the risk of agency problems, i.e. the prospect of capture by management as described in Chapter 3.[51]

**5.16** Under the current Rules, directors on the Group Board are classified as Regional (or "lay") directors, Corporate directors or independent professional non-executive directors ("IPNEDs"). While we believe categorising directors as either executive or non-executive is helpful, we find the distinction between IPNED and lay director unacceptable because it suggests that the former is a properly qualified and experienced director while the other one is not.

**5.17** Accordingly, the Review has taken the firm view that to perpetuate such a distinction is unhelpful and divisive, and runs the inevitable risk of tokenism towards the lay directors and the deliberate creation of second-class citizenship within the boardroom. Moreover, it would be entirely irresponsible, given the scale of the strategic and financial challenges facing the Group, for governance reforms to recommend putting in place on the Board individual directors who were openly acknowledged to be unqualified for the responsibilities that they were taking on.

**5.18** The Review's unequivocal recommendation is therefore that, looking ahead, all Group Board directors should be appointed on merit against clear criteria of skills and experience for the specific positions that the Board needs to fill, if it is to achieve the balanced skill mix that is competitively essential. Individual directors should collectively possess the skill sets and experience required to monitor, challenge and offer sound guidance to the Executive team. The non-executive directors sitting on the boards of the Group's primary competitors provide a useful comparative benchmark.

**5.19** The Review team is optimistic that there are individuals among the Group's vast membership who possess the necessary qualifications to serve on the Group Board and would encourage the NMC to identify and propose them to the Nominations Committee for consideration as Group Board candidates.

**5.20** In recommending that NEDs be "independent", the Review is emphasising the importance of Group Board members not being compromised as fiduciaries by conflicts of interest. In this regard, although Group Board directors from independent societies bring helpful business experience and market knowledge, the Review believes that it is no longer appropriate for those representing societies that are in competition with the Group to continue to serve on the Group Board.

**5.21** The Review believes that having executives as members of the Group Board would enhance collective accountability for corporate performance, which is particularly critical at this juncture as the Group undergoes substantial strategic restructuring. An ongoing executive presence is now a widespread good governance practice on boards of this scale and complexity; it would also help build trust and effective working relationships.

**5.22** Initially, the reformed Group Board should comprise 6 to 7 independent NEDs, two executive directors and an experienced and independent chair with no previous association or involvement with the Group.

**5.23** There is more or less a universal view that the current board is too large and hampers board deliberation and decision-making. Accordingly, the Review recommends reducing the size of the Group Board to a maximum of 10 members.

51 See also Exhibit 24 on efforts to professionalise boards over the past couple of decades.

### Recommendation 2: Remit of the Group Board

- The Board should retain all of its responsibilities under the current Rules
- The Board should also assume the responsibilities of the Subsidiary Boards

**5.24** The Group Board would be responsible for all commercial matters and have full power and responsibility for the management and operation of the Group. Constitutionally, it would essentially retain all of its responsibilities under the current Rules.

**5.25** Its orientation, however, would shift in a subtle but important way. It would no longer have the currently assumed role of representing individual constituencies; instead, it would focus on the overall interests of the Society.

**5.26** After the current restructuring is complete, the Group will have fewer businesses in its portfolio. The Review believes that a reformed Group Board with strengthened capabilities should have the expertise and capacity to effectively direct and oversee the remaining businesses. Accordingly, the Review recommends scaling back the current Subsidiary Boards, with the Group Board subsuming their responsibilities to the extent permitted under the law.

### Recommendation 3: Commitment to co-operative values and principles

- All Group Board directors must be members of the Co-operative Group and demonstrate strong commitment to co-operative values and principles

**5.27** In addition to meeting the demanding criteria to fill specific non-executive positions on the Board, all Group Board directors will be required to be members of the Co-operative Group and demonstrate strong commitment to co-operative values and principles. This will be an important dimension of the Group Board candidate evaluation process and will be confirmed and underscored in all Group Board director letters of appointment. To ensure that NEDs develop a strong commitment to the Group's Values and Principles, they would be encouraged to deepen their knowledge of co-operative history and current developments worldwide, as well as participating on a regular basis in co-operative events (see Exhibit 25 below).

### Exhibit 25 – Proposed approach to verify affinity of NED candidates with Values and Principles

| Approach | Description |
|---|---|
| Demonstrate historical affinity | – The work and personal biographies of candidates will be reviewed to show previous actions, activities and/or affiliations which demonstrate affinity to TCG Values and Principles<br>– The affinity evaluation of proposed candidates will be published to members prior to election at the AGM |
| Letter of appointment | – Each Board member will sign a letter of appointment agreeing to conduct themselves, both inside and outside the boardroom, in a way which is in line with and supports TCG Values and Principles |
| Membership | – Each Board director must be a member of TCG |
| Induction and | – Each Board director will undergo appropriate induction and training which explains the Values and Principles, their heritage, their interpretation and |

| | | |
|---|---|---|
| training | | application along with co-operative developments worldwide |
| Evaluation | – | The annual evaluation of the individual directors and the Board will include Values and Principles criteria |
| Events | – | Each Group Board member will participate regularly in co-operative events |

Source: Review team analysis

**Recommendation 4: Nominations Committee**

- Establish a Nominations Committee to screen and propose Group Board candidates for members' approval at the Annual General Meeting. The committee should comprise five non-executive members, including up to two representatives designated by the National Membership Council

**5.28** The Review realised early in its work that scale and complexity have immense implications for the effective governance of a co-operative, particularly at board level. The detailed mix of specific competences required of the boards of large co-operatives with diverse businesses means that its overall skill mix cannot be left to the unpredictability of the "democratic lottery". It is for this reason that the Review proposes the creation of a Nominations Committee as an objective mechanism that (in conjunction with the other core proposals of the Review) remains fully compatible with ongoing democratic member control and that ensures the Group Board will collectively possess all the required skills and experience needed to effectively lead the organisation.

**5.29** The Nominations Committee has an important professional task to accomplish: it has to ensure that the Group Board has an appropriate balance of skills and experience. When individual vacancies arise, or when the need for a specific new role on the Board is identified, its task is to define the skills and experience criteria against which candidates will be assessed. For an organisation of the Group's size, the normal practice would be for the Nominations Committee to work with a search firm specialising in non-executive director appointments to develop an initial pool of screened candidates who would then be interviewed by the Committee. The nature of the interview process would require Nominations Committee members to possess a strong professional understanding of the criteria they were looking to apply. For this reason, the work is a serious responsibility for Nominations Committee members.

**5.30** Because the creation of the Nominations Committee is an innovative step for the Group to adopt, it is of fundamental importance that it should command credibility as an impartial body working to objective standards and recommending candidates for Board approval on the basis of strictly meritocratic criteria. In order to build confidence in this process, the Review recommends the inclusion of two NMC-designated representatives on the Committee. This would ensure that the objectivity of the process could be seen at first hand by the NMC representatives, and would also enable them to ask questions about the commitment of potential board members to co-operative values and principles. This feature constitutes a substantial enhancement over the practice at listed companies, where the nominations committee typically does not include any shareholder representation.

**5.31** The Nominations Committee would be expected to work in a consensual way to identify the best-qualified candidates for specific Board positions. In the unlikely event of the NMC representatives challenging the objectivity and due process of any particular Committee recommendation, this would be an issue to be addressed in the first instance by discussion between the Board and the Steering Committee of the NMC. The aim, throughout, would be for the Nominations Committee to identify a strong, credible candidate for each new Board appointment.

**5.32** While the regular periodic work of the Nominations Committee would focus on new appointments to the Board, its second ongoing role would be to maintain annual oversight of the balance of the Board in terms of its skills base and its demographic composition. (It would also have a further important role in relation to Board evaluation which is discussed separately below.) This second role would require the Committee to make an annual recommendation to members on the ongoing appropriateness of the Board's composition in relation to its needs. It is on the basis of this recommendation that individual Board members would put themselves forward for election/re-election at the Annual General Meeting. To protect the integrity of the nominations process, Nominations Committee members facing re-election at the next AGM would not participate in any discussion relating to their re-nomination for the Group Board. In the unlikely event that there was any disagreement between NMC appointed members on the Committee and NED members with regard to the appropriateness of recommending any incumbent director for election/re-election to the Board, once again this would be a matter for discussion between the Board and the Steering Committee of the NMC. Nevertheless, while it is important to have provision for the possibility of such disagreement, the objective of this process would be, step-by-step, to build trust between the NMC and the Group Board on the effectiveness and impartiality of merit-based appointments to the Board which, in all cases, would be subject to ultimate approval by the membership as a whole.

**Recommendation 5: Director term and tenure limit**

- Group Board directors should face triennial re-election by the entire membership in a national franchise on the basis of one member, one vote. Group Board directors should retire by rotation so that approximately one-third face re-election each year
- Non-executive directors ("NEDs") should not serve more than six years. An NED may be eligible to serve an additional three-year term (beyond the initial six years of service) with the consent of the National Membership Council

**5.33** The Review recommends an annual national election process for Group Board directors. In contrast to the current competitive system to elect Group Board directors, the proposed electoral process would work as follows: the Nominations Committee would review the skill balance of the Board and, if this balance was felt still to be appropriate, would put forward individual Board members for election/re-election equal to the number of available Board positions. We believe that competitive elections – where the number of candidates exceed the available seats – is not appropriate at Group Board level because the task of the Nominations Committee is to propose a group of candidates that collectively best meets the needs of the board. Moreover, while all candidates should be willing to be evaluated regularly for competence and fit, and be subject to dismissal by a majority of votes against them, individuals of the highest calibre are unlikely to be attracted to a Board that is subject to an electoral process that is based on a different interpretation of democratic member control.

**5.34** Initially, the Review proposed annual re-election for Group Board directors as a way to provide assurance that they will be accountable to members. However, various parties (including senior elected members) expressed concern that one-year terms would create a risk that the entire Group Board could be replaced all at once and expose the Group Board to takeover by activists or carpetbaggers. While the Review team consider this to be a low risk, the Review has agreed to recommend three-year terms for Group Board directors.

5.35 To prevent entrenchment of Group Board directors, the Review recommends a tenure limit for NEDs. In line with UK best practice, the Review team initially considered proposing a nine-year limit. However, in light of concerns among some elected members that nine years is too long, the Review now recommends a six-year tenure limit for NEDs, with the possibility of a further three-year term on the recommendation of the Nominations Committee and with the consent of the National Membership Council.

**Recommendation 6: Comprehensive induction to the Board**

- Put in place a rigorous and systematic induction programme which includes TCG Values and Principles, director duties and a thorough understanding of TCG businesses and markets

5.36 Incoming directors should all receive a comprehensive and timely induction when they join the Board, designed to help them contribute within an appropriately short timeframe and to maximise the quality of their contribution.

5.37 Each induction should be tailored to the incoming NED, according to his or her existing knowledge, experience and needs and should be shaped by the secretariat, the Group Chair and the incoming NED.

5.38 The exact content of an induction programme will vary according to need but will typically include detailed briefing on TCG's business model, its financial structure, the markets in which it operates, the role and aspirations of the Group Board, specific expectations and objectives for NEDs, and the Group's unique governance structure and processes, including the role of the NMC and the significance of TCG Values and Principles.

5.39 Any induction should include opportunities to engage broadly and to start to build relationships with other members of the Group Board, the NMC and management.

**Recommendation 7: Board evaluation**

- The Group Board should conduct a formal and rigorous evaluation of its performance annually, and this should be used to shape the nominations strategy and any programme of board development

5.40 More and more organisations are recognising the value of holding regular board evaluations to improve the effectiveness of their boards. This is now recognised as best practice, as set out in the UK Corporate Governance Code and the Co-operatives UK Corporate Governance Code for Consumer Co-operative Societies.

5.41 For TCG, the Nominations Committee, in conjunction with the Group Chair, should be responsible for scoping and commissioning an annual board evaluation.

5.42 The evaluation should cover the different aspects of board effectiveness. This should focus on its regular working practices and boardroom dynamics and would include the Group Board's balance of skills and experience, its affinity to and incorporation of TCG Values and Principles and its diversity of membership.

**5.43** The full evaluation report should be discussed by the Group Board and the Nominations Committee; the Chair should be responsible for ensuring appropriate action is taken as a result of the evaluation recommendations. The report should inform the nomination and appointment strategy and the programme of board development.

**5.44** The Group annual report should include a description of how the evaluation was conducted and how any development needs are being addressed.

**5.45** Unless there is a compelling reason otherwise, the evaluation should be externally facilitated at least every three years.

**Recommendation 8: Board policies and practices and role of the company secretariat**

- The Group Secretary should re-assess methodically the adequacy of current board-level policies and working practices
- The role of the company secretariat should be strengthened

**5.46** The Review has undertaken a preliminary review of the working processes of the Board. It is evident from this initial work that a comprehensive review is now needed to develop a revised set of policies covering matters reserved for the Board, delegated authorities and accountability requirements, and management of conflicts of interest relating, inter alia, to board meeting protocols and Group Board directors serving on the boards of affiliated or "sister" organisations. The Group Secretary should also systematically review regular Group Board working processes, including agenda setting, circulation of Group Board papers and production of Group Board minutes.

**5.47** The role of the company secretariat needs to be strengthened. The governance framework that this Review is proposing will reinforce the existing need for much tighter co-ordination between the Group Board, the Executive and the National Membership Council and Steering Committee. At present, responsibilities for liaison and interaction with the membership are inconsistently and too widely dispersed. This results in inadequate and sometimes unreliable communication practices. Ensuring that the company secretariat is empowered to act effectively in support of the Chair, the Group Board and the NMC is of central importance to the future effectiveness of the Group's overall governance.

**Recommendation 9: Performance metrics**

- Reporting to the Group Board should focus on key performance metrics of the individual businesses, overall capital management and the extent to which individual businesses are earning more than their cost of capital
- The Executive should extend its reporting to the Group Board on the risk exposures that TCG carries on its financial strategy

**5.48** A consistent theme of this Review has been the critical need for disciplined financial management. Long-standing failures to generate adequate surpluses to fund future growth have led to an erosion of the Group's position in a number of markets and notably in food retailing. Since the co-operative ownership model does not provide access to equity markets and thus relies on internally generated equity, it is essential that investment decisions and the Group's overall debt to equity position are managed with particular attention to risk exposures and return on capital. This is not simply a matter for the Executive. It is a central responsibility of the Group Board to ensure that directors have, collectively and individually, a sound understanding of the Group's overall financial strategy and how this underpins the operating models of its various businesses. In parallel, the Group Board needs to understand and regularly review the key non-financial performance metrics of the Group's businesses, so that it can engage in the disciplined probing and challenging of the Executive team that is the hallmark of a well-functioning board that is exercising proper stewardship.

## *A new National Membership Council*

**Recommendation 10: Remit and composition of NMC**

- Establish a National Membership Council of approximately 50 members, including 10 seats for Group employees, up to five for independent society representatives and up to five seats for "special constituencies"
- The President of the NMC shall be elected by NMC members for a term of two years. The NMC President shall be permitted to serve a maximum of six years

**5.49** The role of the National Membership Council is three-fold:

- First, to act as a consultative body that would regularly engage with the Group Board and hold it to account for its stewardship and strategic leadership of the organisation and for the operational performance of the Group. As detailed above, it would also play an important role in the nomination of Group Board directors
- Second, to provide a forum in which the interests of its diverse membership can be represented and promoted
- Third, to serve as the guardian of the Group's commitment to co-operative values and principles and to ensure that these are reflected in its corporate vision, strategy and operating practices

**5.50** To fulfil its responsibilities, the NMC will have the rights and powers as set out below:

**...as guardian of Values and Principles of the constitution**

- To advise Group Board on ethical matters, with supporting evidence on likely impacts on business performance and values
- To review the Group Board's proposal on distribution before presentation to the membership for approval
- To oversee the social goals programme in accordance with philosophy approved annually by membership at the AGM
- Right to allocate distributions designated by the Group Board for community causes, subject to guidelines approved by membership on the alignment of community spending with the Group's priorities in individual localities
- To hold the Group Board to account on

**...to hold Group Board to account for its stewardship and leadership**

- To be consulted on key strategic and operational initiatives and any aspects of the management of the business, subject to legal and regulatory requirements
- To require the Group Board, CEO and CFO to attend NMC meetings at agreed intervals and in specified circumstances to answer questions
- To appoint up to two representatives to sit on the Nominations Committee
- To require the Group Board to explain in the annual report where it has not followed NMC advice and why
- To issue an annual report to the full membership on performance of Group Board, including the Nominations Committee

matters which relate to the Group Values and Principles

- To ensure that any future changes to the revised constitution did not weaken its adherence to Co-operative Values and Principles

- To approve requests for a NED to be nominated for an additional three-year term

**5.51** The Review recommends that arrangements are put in place to safeguard the confidentiality of information shared by the Group Board and Executive with NMC members.

**5.52** In light of concerns expressed that the originally proposed 100-seat NMC would be too large to be of practical value, the Review now recommends that the 50 seats on the NMC should be allocated as follows:

- 30 seats for non-employee Individual Members
- 10 seats for Group employee members
- Up to five seats for Independent Society Members
- Up to five seats for special constituencies

**5.53** The case for a reserved employee constituency is strong and has support from a broad range of TCG stakeholders, including a large number of those who made submissions to the Review website. Various organisations – investor-owned and mutual – recognise that a motivated and dedicated workforce is a critical advantage and the Group itself aims "to be an exemplary employer". At present, the Group has approximately 90,000 employees and this proposal is designed to encourage their increased involvement in membership.

**5.54** Employees can and should be one of the primary ambassadors to demonstrate to customers and others the distinctive "Co-operative difference". The aim of this proposal is to establish appropriate mechanisms to ensure that their distinct concerns, interests and preferences can be more adequately taken into account.

**5.55** To provide representation for emerging or underrepresented categories of members, and to encourage their development, the Review proposes allocating up to five seats for "special constituencies" such as the Young Members' Board. The Review recommends empowering the NMC to allocate these seats as appropriate recognising, however, that not all of these places need to be allocated at inception.

**5.56** The Review recommends that the President of the NMC should be elected by NMC members for a term of two years. The NMC President should be permitted to serve a maximum of six years.

**5.57** The NMC is expected to meet quarterly. An illustrative annual agenda of NMC meetings is set out in Exhibit 26.

**Exhibit 26 – Illustrative NMC annual agenda**

| Month | Planned topics for discussion* |
|---|---|
| March | – Application of TCG Values and Principles to Group operations<br>– Review of strategy and national business performance<br>– Member feedback<br>– Projects and working groups update<br>– Finalisation of NMC annual statement (including relating to Group Board performance)<br>– Proposed distribution |
| June | – Values and Principles and the Group strategy<br>– Social goals programme and community building initiatives<br>– Progress review of internal change programme<br>– Projects and working groups update |
| September | – Review of national business performance<br>– Membership training and development – allocation of funds and results achieved<br>– Member feedback<br>– Projects and working groups update |
| December | – Group branding and marketing update<br>– Diversity policies and results achieved<br>– Annual NMC activity review and priorities for next year<br>– Projects and working groups update |

* This is for illustration purposes only. Additional agenda items will arise during the course of the year

**5.58** NMC members should be permitted to form sub-groups based on geography, interests or other agreed criteria.

**5.59** In keeping with fundamental co-operative principles on the development of members, the Review recommends the allocation of appropriate resources, to be agreed annually between the Group Board and the NMC, to provide suitable training and education for NMC members.

**5.60** The Review proposes that members of the NMC receive an annual fee of £6,000 (all inclusive except for expenses incurred) and members of the Steering Committee receive a supplementary annual fee of £4,000 (all inclusive except for expenses incurred), such amounts to be reviewed annually by the Nominations Committee.

**5.61** As discussed previously, this Report will not make recommendations on all matters raised in the Review and suggests that the NMC take responsibility for developing proposals on the following matters for members' approval:

– Whether the eligibility requirements to stand for NMC seats should be set above the proposed requirements set out below

– The appropriate subscription fee for Group membership

**5.62** Given that the National Membership Council will be given full responsibility for oversight of all matters relating to Values and Principles and ethical conduct in the management of TCG businesses, the Values and Principles Board and all Regional Values and Principles committees will be disbanded as part of this process. To ease transition and ensure continuity, the Review recommends giving seats on the NMC at inception to all members of the Values and Principles Board and the chairs of the Regional Values and Principles committees.

**5.63** Similarly, since the NMC will serve as the representative forum for the entire membership, it will replace the Regional Boards which will correspondingly be disbanded.

**Recommendation 11: Remit and composition of Steering Committee**

- Establish a 12-member Steering Committee, with its membership drawn from the NMC as follows:
  - Seven non-employee Individual Member representatives
  - Two employee member representatives
  - Three Independent Society Member representatives

**5.64** The Steering Committee is intended to help coordinate the activities of the NMC and serve as a nexus for interactions between the NMC and the Group Board, the Executive and the membership.

**5.65** The responsibilities of the Steering Committee include:

- Developing the three-year NMC plan for approval by the NMC
- Determining the allocation of the NMC annual budget (budget to be decided by the Group Board according to affordability and other relevant criteria)
- Deciding the agenda for each NMC meeting
- Following up with the Group Board and/or Executive on any outstanding matters after each NMC meeting
- Commissioning research on topics within the remit and allocated budget of the NMC
- Developing the annual statement of the NMC (including on the performance of the Group Board)

**5.66** The Steering Committee is expected to meet six times a year. These would include quarterly meetings to coincide with the quarterly NMC meetings. It is also proposed that two additional meetings be convened, one for potential strategy review with the Group Board and Executive; the second, for the development of future plans for the work of the NMC itself.

**Recommendation 12: Electoral system for the NMC**

- Non-employee Individual Members and employee members of the NMC should be elected through geographical constituencies, each for a term of three years on the basis of one member, one vote
- NMC members may not serve more than nine years in any 12-year rolling period
- Members of the Steering Committee should be appointed for two-year terms and be eligible to serve for a maximum of six consecutive years
- The chair of the Steering Committee will be elected by Steering Committee members for a term of one year. The Steering Committee chair will be permitted to serve a maximum of three years

**5.67** Given the severity of the financial constraints and organisational challenges facing the Group, the need for this Review to recommend a comprehensive framework of governance reforms has been urgent. In completing work on these core recommendations, the Review has identified a number of subsidiary but pertinent issues relating to the allocation of NMC seats that, as an immediate next step, need to be resolved at the requisite level of detail. The Review makes the following recommendations to guide the development of detailed proposals in this area:

- The 30 seats for non-employee Individual Members should be divided into 30 separate geographical constituencies, the boundaries of which should be devised by a suitably qualified organisation such as the Electoral Reform Services
- The 10 seats for Group employees should be allocated according to one or a combination of the following criteria: (a) business line, (b) geography and/or (c) job function
- The five seats for Independent Society Members at inception should be constituency-wide positions, elected as at present. The reserved Corporate seats should be reduced on a sliding scale if the aggregate proportion of "purchases" by Independent Society Members falls below the agreed thresholds
- The five seats for "special constituencies" should be allocated by the NMC on an as needed basis. The Review recommends granting an NMC seat to the Young Members' Board at inception

**5.68** Terms for NMC seats should be staggered so that approximately one-third of members under each category face re-election each year.

**5.69** The Review proposes the following eligibility requirements for NMC seats:

- Non-employee Individual Member constituency: The current requirements for standing for an Area Committee seat
- Employee member constituency: The current requirements for standing for an Area Committee seat plus having worked as a Group employee for at least one year
- Independent Society Member constituency: The current requirements for standing for a Corporate seat on the Group Board

– Special constituency: The relevant current requirements for standing for an Area Committee seat

**5.70** Employee members should be permitted to vote only for employee constituency seats on the NMC.

**5.71** The Review recommends that non-employee Individual Member, employee and Independent Society Member seats on the NMC should be filled through competitive elections. The method for filling special constituency seats should be decided at the time each such seat is created.

**5.72** Members of the Steering Committee should be chosen from incumbent NMC members through category-specific elections by NMC members.

**5.73** The reserved Corporate seats on the Steering Committee should be reduced on a sliding scale if the aggregate proportion of "purchases" by Independent Society Members falls below the agreed thresholds.

**5.74** Members of the Steering Committee should be appointed for two-year terms and be eligible to serve for a maximum of six consecutive years.

**5.75** The chair of the Steering Committee will be elected by Steering Committee members for a term of one year. The Steering Committee chair will be permitted to serve a maximum of three years.

**Recommendation 13: NMC and Steering Committee accountability**

– The NMC and Steering Committee would be responsible for providing an annual account of their activities to members

**5.76** The NMC forms an integral part of the future governance structure of the Group. It provides a regular forum for elected members to engage with the Group Board and Executive on any topic of interest or concern to members in relation to the Group's activities, conduct and broader goals. It has a correspondingly important accountability to members that it should meet through the annual provision of a detailed account of its activities and plans.

**Recommendation 14: Secretariat and resources**

– Establish a secretariat and allocate budget to support the NMC and Steering Committee

**5.77** The NMC and Steering Committee will require administrative support. A secretariat should be created and appropriately resourced to ensure the responsibilities of the NMC and Steering Committee can be discharged effectively and efficiently.

**5.78** The annual budget for the NMC, Steering Committee and secretariat should be decided in conjunction with the Group Board and the Executive.

**Recommendation 15: Area committees**

– The role and function of the Area Committees should be redefined in line with the Group's new Purpose and Strategy, and reinforced to focus on building local membership and supporting community initiatives aligned with the development of the Group's priorities in individual localities

- The number and boundaries of Areas should be reviewed to assess the case for rationalisation and a better fit with the needs of individual localities, and potentially redefined to be the same as those of the non-employee Individual Member constituencies of the NMC
- Area Committee membership should be decoupled from the democratic process

**5.79** Area Committees will have a continuing but redefined role, focused on coordinating front-line activities. It will, however, no longer play a constitutional role (e.g. proposing and electing Group Board directors, serving as a channel for members to rise up the electoral hierarchy).

**5.80** While Area Committees will cease to have a constitutional role, there are a variety of valuable roles for them to assume in relation to commercial matters and promotion of Values and Principles. These include:

- Building the brand and becoming advocates of TCG own-brand products
- Educating local communities about co-operation and recruiting future members
- Contributing local knowledge, e.g. playing a role in finding future store sites
- Raising funds in the community to be distributed to community causes

## *Extended membership rights*

**5.81** The Review team was surprised by the weak constitutional rights of members and their limited ability to influence how funds for social goals are channelled.

**5.82** "One member, one vote" has been a core principle of co-operative ownership, yet at present ordinary members do not have the right to participate at the apex of the governance structure (i.e. attend Society General Meetings or vote to elect or re-elect Group Board directors). The recommendations set out in this section, therefore, seek to reaffirm the importance of direct participation in the affairs of the Society.

**Recommendation 16: Constitutional rights extended to the wider membership**

All Individual Members will be accorded the following new rights:

- Right to elect Group Board members
- Right to attend Society General Meetings
- Right to approve significant transactions
- Right to approve social goals programme
- Right to approve distributions
- Right to elect NMC members
- Right to put forward a motion to a Society General Meeting
- Right to propose candidates for the Group Board

5.83 Some of the Review's recommendations – such as to grant all members the right to elect Group Board directors and attend and vote at Society General Meetings – were considered in the 2007-2009 Constitutional Review but were ultimately not adopted.

5.84 When CWS was a wholesale society, the reason for restricting attendance at Society General Meetings to designated "delegates" of corporate societies was understandable. As the vast majority of TCG members are now individuals, the current delegate model is no longer suitable.

5.85 For the reasons stated above, the Nominations Committee should be the primary mechanism for screening and proposing candidates for the Group Board for members' approval at the AGM. However, it is recognised that there may be exceptional circumstances when members should be granted the right to nominate their own Group Board candidates to be voted upon by the membership:

- The reason that recourse to this provision would be exceptional is that the primary objective of the Nominations Committee is to establish itself as a body that commands the full confidence and trust of the membership as a whole and its elected members on the NMC. With confidence in the objectivity of the Nominations Committee in its recommendations of individual Board candidates for regular election/re-election, there is no automatic need for contested elections to the Group Board. And for reasons set out earlier in this chapter, there is a strong requirement for the Board to comprise individuals who possess the specific skill sets that, taken together, will provide effective, informed governance

- However, the Review recognises the need to provide a mechanism for exceptional purposes that would permit an electoral contest for an individual Board seat. A particular issue is the need to strike the right balance in establishing an appropriate threshold for valid nomination of outside candidates in such cases. The Review has heard repeated concerns that to make the threshold too low increases the vulnerability of the Group to Board capture by single-issue activists and carpetbaggers interested in demutualisation. Equally, however, the threshold should not be so high as to render this option unavailable in practice

- Any candidate nominated by members through this alternative mechanism must meet the skills and competence requirements set out by the Nominations Committee in the relevant vacancy specifications

- The specific requirements (including the number of signatories needed for nomination and the mechanism for confirming the competence of nominated candidates) and procedures should be devised by a suitably qualified organisation such as the Electoral Reform Services

5.86 "Significant transactions" should be defined in accordance with the Financial Conduct Authority's Listing Rules standards for determining transactions where prior shareholder approval would be required.

**Recommendation 17: Revision of Membership Register and strengthening connectivity**

- The Membership Register should be radically updated and revised to ensure accuracy and comprehensiveness
- TCG should expand its use of modern technologies – including social media, webinars and live webcasting – to connect with members (to understand their wants and needs), facilitate discussion and debate, share information and conduct members' meetings
- The National Membership Council, in conjunction with the Board, should review the membership fee with the view to ensuring that members value belonging to the Co-operative

**5.87** As Group Chair, Ursula Lidbetter, has put it, "*Social media was invented for co-operatives*". It provides an array of innovative mechanisms to identify the interests of members, conduct discussion and debate, form communities of members with shared interests and identify new opportunities for co-operation.

**5.88** The rapid advances in communications technologies mean members can now meet without having to convene physical "town hall" meetings, which appear increasingly to be more suited for the pre-digital age. To meet the demands of members – as conveyed in their submissions to the Review website – for modern means of interaction, the Review recommends convening electronic members' meetings where possible.

**5.89** Correspondingly, connectivity between the Group and the membership can be strengthened through, for example, a regular webinar by the Group Chief Executive to discuss business issues.

**5.90** Leveraging modern technology to connect the membership means there is potential to scale back the Group's costly membership support infrastructure.

**5.91** However, the current state of the Membership Register is highly unsatisfactory. Details on Individual Members have not been consistently recorded, and the Group is at present unable to connect efficiently with a large proportion of its membership. As a start, it needs to make a comprehensive effort to ensure that, wherever possible, it has valid email addresses of members. But this is only the first step. It then needs to develop ways to include details on members' interests and preferences and what they seek from their membership. The potential benefits of developing a comprehensive up-to-date Register are self-evident.

**5.92** It is, moreover, an essential foundation for a flourishing member-owned organisation that it needs to have reliable electoral information in place. To ensure that the broadening of one member, one vote can be exercised by members effectively, a complete and accurate membership register is essential. Without it, the integrity of voting results will be undermined and subject to challenge.

**5.93** A second area needing attention is the appropriateness of the present membership fee.

**5.94** At CWS's founding in the mid-nineteenth century, the membership fee of £1 equalled a one and half week's salary. The Review understands that the subscription fee has never been changed, even though £1 is no longer a meaningful amount. For the sake of comparison, £1 at the time of CWS's founding would be worth around £90 today after adjusting for inflation and 1.5 week's wages would approximate £675.

**5.95** Accordingly, the Review recommends that the National Membership Council review at the earliest possibility whether the membership fee should be raised to ensure that members value their membership in the Co-operative sufficiently. Its findings and recommendations should be reviewed with the Group Board for potential submission to the entire membership for approval.

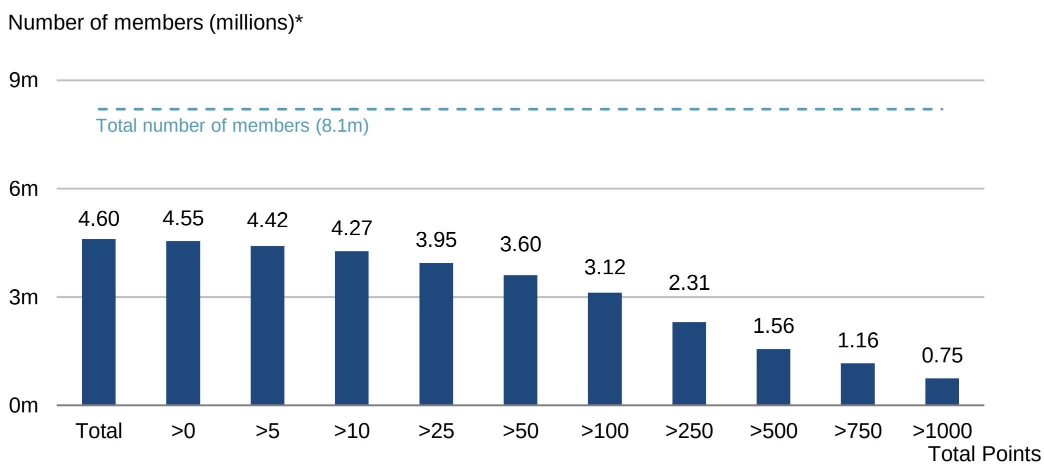
### Recommendation 18: Exercise of constitutional rights

- Voting rights in Society General Meetings should be one member, one vote
- Independent Society Members should be granted additional voting rights based on purchases but the total votes cast by Independent Society Members in a Society General Meeting should be capped at the aggregate proportion of their purchases
- Introduce transaction-based criteria for exercising constitutional rights to ensure a proper alignment between members and the Group
- Introduce proxy voting to facilitate the exercise of voting rights

**5.96** The Review recommends that voting at Society General Meetings be conducted on the basis of one member, one vote, with the exception that Independent Society Members will be granted additional voting rights based on their purchases with the Group. To ensure that Independent Society Members do not exert influence in an inequitable manner, the total votes cast by them collectively should be capped at the aggregate proportion of their purchases (which stands at approximately 22 percent based on trade in 2013). Further consideration of how this voting mechanism works in practice should be given to ensure voting remains equitable for both categories of members.

**5.97** The Review believes that members who choose to exercise their constitutional rights should have a continuing relationship with the Group and therefore recommends that the Group introduces transaction-based criteria for the submission of motions to and attendance at Society General Meetings and voting in elections and on other resolutions. The 2013 data on members' transactions with the Group and voting turnout is provided below to serve as reference for the development of an appropriate threshold.

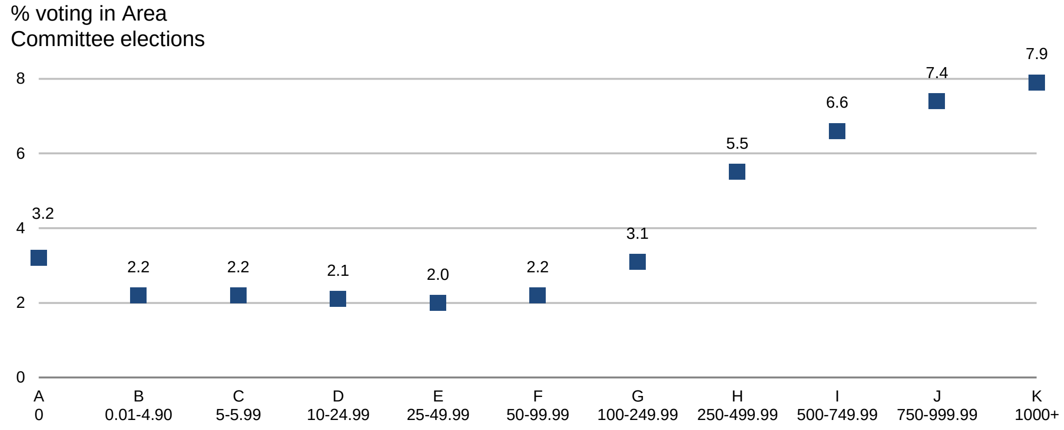
### Exhibit 27 – Profile of members by point accumulation in 2013




*These figures include General Insurance but exclude transactions with the Bank. If transactions with the Bank were included, the total would be 5.6 million members

Source: TCG Group marketing

## Exhibit 28 – Percentage of members voting by point band in 2013 *




*These figures include General Insurance but exclude transactions with the Bank

Source: TCG Group Marketing

**5.98** Presently, Delegates to Society General Meetings are able to exercise their voting rights only if they are physically present. With the proposal to extend voting to the broader Membership base, it will be necessary to introduce proxy voting, as it will not be possible for all members to physically attend Society General Meetings.

**5.99** Prior to each Society General Meeting, members should be given an opportunity to register their interest to participate in person. While the Group should make every effort to find a suitably large venue, if the number of members wishing to attend in person exceeds the capacity of available meeting venues, the available seats should be allocated by the drawing of lots.

**5.100** The Review also recommends that all Society General Meetings be broadcast over the internet and all members be permitted to submit questions in advance of a Society General Meeting.

**5.101** To encourage members to participate in voting, the Group should consider offering to make a charitable contribution for every vote cast.

### Recommendation 19: Social goals

- Focus social goals on community building activities closely aligned with, and specifically reinforcing, the strength of the Group's franchise and customer base in the marketplace and communities that it serves
- Give members a direct say in how contributions are channelled

**5.102** The Review believes that the Group should once again embrace the Rochdale Pioneers' philosophy of focusing on the provision of quality goods and services at competitive prices and focusing social goals activities on local community-building, aligned closely with the Group's business priorities in individual localities.

**5.103** TCG should also give members a direct say in how distributions are channelled through, for example, the Annual General Meeting or when they transact with the Group.

**5.104** Giving members greater say over the distribution of funds will not only help engage them but it will diminish the possibility of attracting people with motivations that are not in accord with the central mission of the Co-op. In essence, it will help reduce the scope for exploiting "private benefits".

**Recommendation 20: Protection of rights of Independent Society Members**

- The voting and dividend rights of Independent Society Members need to be protected under the new governance arrangements
- In the event of a resumption of dividends, Individual members and Independent Society Members should benefit proportionately, as measured by purchases
- The CRTG pooled purchasing arrangement and other federal relationships between the Group and independent societies should be formalised as soon as possible

**5.105** As the Society's founding Independent Society Members will no longer have any reserved seats on the Group Board, the Review recommends that they be provided assurance that their legitimate interests – including voting and dividend rights – will not be harmed.

**5.106** Additionally, as explained above, Independent Society Members would be allocated three of the 12 seats on the Steering Committee of the NMC to ensure that they retain an ongoing voice in influencing and helping shape the future of the Group.

**5.107** Moreover, the Review recommends that, to provide greater predictability and certainty to all parties concerned, the CRTG pooled purchasing arrangement and other federal relationships between the Group and independent societies should be formalised as soon as possible. This should include the establishment of a board chaired by an independent non-executive director, arm's length dealing and a minimum operating life. The principles and terms of reference for a formalised CRTG should be agreed by 31 July 2014.

**Recommendation 21: Demutualisation protection**

- In order to safeguard the Group's status as a co-operative society, consideration should be given to implementing measures to provide protection from demutualisation for improper purposes. Such measures could include the procedure to submit motions to and/or requisition a Society General Meeting, voting methodology in NMC elections and defining with care the "qualifying members" who are entitled to vote on a resolution to demutualise

**5.108** The Group had a searing experience in the mid-1990s when a serious attempt to demutualise the organisation was mounted by Andrew Regan. As a result, there is a continuing concern to ensure that predator protection is as strong as possible. An early attempt to build in such protection was the development of the deliberately complex three-tier electoral hierarchy, since this created an entrenched Regional structure with the power to block constitutional change.

**5.109** Regrettably but predictably, this particular form of predator protection has resulted in a highly dysfunctional governance structure for normal purposes. It is therefore important that any future protection is designed in such a way that it does not impede and frustrate good governance for everyday purposes and pays proper regard to the

Financial Conduct Authority's interest in ensuring that the legitimate decision rights of members are adequately safeguarded in the Society's Rules.

**Recommendation 22: Implementation path**

- The Group Board should immediately initiate all necessary processes for the rapid implementation of comprehensive governance reform
- The Group Board should convene Special General Meetings by (a) 15 July 2014 to approve proposed new Rules relating to the "firm" recommendations in this Report and (b) 30 September 2014 to approve additional new Rules implementing the remaining Review proposals
- Implementation should begin as soon as possible after approval by members of the full set of new Rules and be completed by the 2015 Annual General Meeting

**5.110** The dire financial, organisational and commercial predicament of the Group means that the Group Board must act with utmost swiftness to implement radical governance reform.

**5.111** The Review believes that transition to a new governance framework can begin immediately and is proposing an implementation plan in Chapter 6.

**Recommendation 23: Group Board functioning prior to adoption of new governance framework**

- Establish an interim board committee with broad authority to interact with, guide and support the Executive prior to the adoption of the new governance framework.

**5.112** At this critical juncture – with the impending roll-out of a new Purpose and Strategy, ongoing restructuring of the Group's business portfolio and significant organisational and financial decisions looming – the Executive needs a more effective structure to interact with the Group Board.

**5.113** As the existing Group Board set-up has consistently failed to provide the requisite guidance and support to the Executive, the Review recommends the establishment of an interim board committee with broad authority delegated by the Group Board (pursuant to the existing Rules) to serve as the primary point of interaction with the management team. Under this arrangement:

- The interim board committee will meet monthly and discharge most of the Group Board's oversight and challenge responsibilities
- The Group Board will meet quarterly and focus on long-term strategic and Values and Principles issues
- Matters requiring formal Group Board approval will be decided at its quarterly meeting or by written resolution of the Group Board, in each case with comprehensive supporting materials and endorsement by the interim committee
- Existing Group Board committees and the Values and Principles Board will operate as normal but the activities of the Subsidiary Boards will be scaled back

**5.114** The interim board committee should comprise the following members:

- Group Chair
- Chair of the Group Audit and Risk Committee
- Chair of the Group Remuneration and Appointments Committees
- Two members of the Executive (most likely the CEO and CFO)
- One to two IPNEDs from the Subsidiary Boards

**5.115** This arrangement will operate until the reformed Group Board is in place (expected in November 2014).

# Chapter 6: Proposed implementation plan

## Introduction

6.1 For all the reasons set out in the previous chapters, the Review cannot stress enough the urgency of implementing comprehensive governance reform. To help ensure that the next stage will not be delayed by protracted discussions and debate and result once again in the "fudging" of desperately needed reform, the Review sets out below a proposed implementation plan.

6.2 The Review's proposed implementation arrangement involves three elements:

- Overall timetable for implementation
- Leadership group to spearhead reform
- Transitional arrangements

## Overall timetable for implementation

6.3 The Review believes it is feasible and critical for the reforms set out in this Report to be implemented in full by the Annual General Meeting in May 2015.

6.4 As many of the recommendations in the Report – including simplifying the electoral system, reducing the size of the Board and appointing executive directors – have been proposed in the past and, given the engagement with elected members to discuss the proposed reforms over the past several months, any resistance to swift implementation will not be the result of a lack of understanding but a lack of conviction to pursue meaningful reforms.

6.5 To complete implementation of its recommendations by the 2015 AGM, the Review proposes the following milestones:

- *By the beginning of June 2014*: Commission work and agree consultation process and timescales for finalising Review recommendations requiring further detail (e.g. NMC constituencies, voting methodology, trading thresholds for qualifying members)
- *By 15 July 2014*: Hold a Special General Meeting to approve proposed new Rules relating to all "firm" Review recommendations (i.e. those not requiring further detail)
- *By 1 September 2014*: Complete consultation process and finalise the design of the remaining Review recommendations
- *By 30 September 2014*: Hold a Special General Meeting to approve proposed new Rules for the remaining Review recommendations (FCA registration of the full set of new Rules will be sought following this meeting)
- *1 November 2014 ("Day 1")*: Install the Day 1 Group Board, National Membership Council and Steering Committee. Form Nominations Committee (with NMC representation) and begin process to identify and propose Group Board for members' election at the 2015 AGM
- *1 February 2015*: Hold elections for the National Membership Council

– *2015 AGM*: Install full National Membership Council and present Group Board directors to the membership for individual election

## Leadership group to spearhead reform

**6.6** To provide co-ordination, leadership and momentum, the Review proposes the establishment of an Implementation Committee to spearhead the reform effort.

**6.7** The Implementation Committee should include no more than six individuals. It is crucial that every member of this committee is fully convinced of the urgent need for fundamental reform, willing to champion it publicly and capable of comprehending how different reform elements complement one another and contribute to the whole.

**6.8** The Implementation Committee should be led by the Group Chair and include a combination of the Group Chief Executive, another member of the Executive, one or two other Group Board directors and possibly an IPNED from a Subsidiary Board. To provide an impartial perspective, it would be desirable to appoint to the committee a highly respected individual of unquestioned integrity from outside the Co-operative Movement who commands respect among co-operators and non-co-operators alike. Such a person may have a background as a senior commercial partner in a major legal practice or a leader from the highest echelon of the civil service, academia or major charity.

**6.9** The Implementation Committee should be supported by a highly capable and experienced project team (perhaps sourced from a respected external consultancy) to manage the various dimensions of reform implementation and help anticipate, manage and resolve – in a rigorous and dispassionate manner – the intricate technical, organisational and political issues that will inevitably arise.

**6.10** The Implementation Committee should transfer any remaining tasks to the new Group Board starting on 1 November 2014 and wrap-up its activities by 31 December 2014.

## Transitional arrangements

**6.11** The Review has considered transitional arrangements for the Group Board, National Membership Council, Steering Committee, Regional Boards and Area Committees, with the view to facilitate rapid implementation, reducing disruptions and ensuring sufficient continuity.

**6.12** Given the lingering sensitivity over previous arrangements that many members deemed to be overly generous, the Review believes strongly that any provisions for loss of office resulting from the adoption of a new governance structure would need to be put before the membership for its approval.

**6.13** The Review believes that on 1 November 2014 ("Day 1"), the Group Board and NMC should have enough members to be functional but not necessarily be filled to capacity. All members of the Day 1 Group Board and NMC will face elections within six to nine months of their appointment.

**6.14** The Review's proposal is summarised below.[52]

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52 See Exhibit 29 for an overview of the proposed timeline for transition.

## Exhibit 29 – Transitional arrangements

| | 2014 | | | | | | | | 2015 | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | May | June | July | August | September | October | November | December | January | February | March | April | May | June |
| **Milestones** | 17 May AGM / SGM | Finalise process and timescales | SGM Approve firm recommend-ations | 1 Sept Finalise new frame-work | 30 Sept SGM to approve new rules + send to FCA for registration | | 1 Nov “Day 1” | | | 1 Feb NMC elections | | | AGM Full implement-ation of reform + Group Board elections | |
| **Implementation Committee** | **Implementation Committee** | | | | | | | | | | | | | |
| **Group Board** | **Group Board**<br>– Focus on long-term strategy and V&P | | | | | | | | | | | | | |
| | **Interim Board Committee**<br>– Primary point of interaction with Executive<br>– Responsible for oversight and challenge | | | | | | | | | | | | | |
| | | | | | | | **Day 1 Group Board**<br>– 4-6 members<br>– Additional members to join as identified by Day 1 Nominations Committee | | | | | | **Permanent Group Board** | |
| **Nominations Committee** | | | | | | | **Day 1 Nomination Committee**<br>– Members drawn from Day 1 Board and Day 1 NMC | | | | | | **Permanent Nomination Committee** | |
| **NMC** | | | | | | | **Day 1 NMC**<br>– 30-40 members drawn from current elected members | | | | | | **Permanent NMC** | |
| **Steering Committee** | | | | | | | **Day 1 Steering Committee**<br>– 5 members drawn from Day 1 NMC | | | | | | **Permanent Steering Committee** | |
| **Regional Boards** | **Regional Boards** | | | | | | | | | | | | | |

### Group Board

**6.15** On Day 1, the Group Board would have the following members:

- 1 to 2 IPNEDs from Subsidiary Boards
- Two executives (most likely Group Chief Executive and Finance Director)
- 1 to 2 new INEDs

**6.16** The Group Board chair should be independent of management and elected by the non-executive members from among their number.

**6.17** Members of the Day 1 Group Board should be selected by the Implementation Committee with the assistance of a recognised executive search firm, whose role would include devising the collective and individual director skills and experience specifications for a board of the Group's scale and complexity. IPNEDs from Subsidiary Boards interested in applying for the Day 1 Group Board will be considered on an equal basis – in terms of skills and experience – as other candidates. To enhance the legitimacy of the transitional Group Board, a highly respected and demonstrably impartial public figure should be appointed to oversee the selection process.

**6.18** The responsibilities of the Subsidiary Boards will be formally scaled back on Day 1.

### National Membership Council

**6.19** On Day 1, the NMC would comprise the following members:

- All Group Board members (20)
- All chairs of Regional Boards (7)
- All chairs of Regional Values and Principles committees (7)
- 5 employees (drawn from the pool of employees serving on Regional Boards)

Any of the elected members mentioned above may, of course, decline to serve on the NMC, in which case such seat(s) would remain vacant until the first NMC election in 2015.

NMC members would elect their own President.

### NMC Steering Committee

**6.20** On Day 1, the NMC Steering Committee would comprise the following members drawn from the transitional NMC:

- Two Group Board members (one Regional director and one Corporate director)
- One Regional Board chair
- One chair of a Regional Values and Principles committee
- One employee representative

Steering Committee members would elect their own Chair.

### *Regional Boards*

**6.21** All Regional Boards will be disbanded on Day 1. However, because all Regional Board members occupy seats on Area Committees, they will still retain a formal role in the Society until the future of the Area Committees is decided.

### *Area Committees*

**6.22** All Area Committees will remain on Day 1, pending the redrawing of their boundaries and remit. However, they will no longer play a constitutional role (e.g. exclusive right to propose and elect Group Board members etc.)

# Chapter 7: Concluding reflections

**7.1** I would like to end this Review with some concluding reflections on the failure of governance at the Co-operative Group and some implications for the future.

**7.2** Throughout the account I have set out in the preceding pages, one constantly recurring theme has been the failure of the Group Board directors to understand the scope of their duties. Despite the debacle at The Co-operative Bank and the clear evidence of governance failings at the level of the Group Board, there has been a general reluctance within the Board to acknowledge – openly and fully – the role that directors collectively, and in some cases individually, have contributed to this outcome. The AGM later this month will provide an opportunity for them to do so.

**7.3** A related matter of deep concern has been the sequence of leaks from the Board during this exceptionally difficult time for the Group when the need for exemplary behaviour by individual directors could not have been higher. It is deeply shocking that these leaks occurred, with all the consequential damage they have caused to the Group and the interests of its employees. This is the extreme manifestation of the failure of this Board to act at all times with a proper sense of collective responsibility, as explicitly required in the Group's own Code of Conduct. The failure to observe this principle is not just a minor matter that can be overlooked or swept under the carpet; it strikes at the heart of effective Board governance and destroys mutual trust. That this should happen in, of all places, the Co-operative Group, with its proclaimed commitment to the highest ethical standards, is a source of shame. The Board has appointed Kroll to report on this matter. The outcome of this may have consequences under the Financial Conduct Authority's Disclosure and Transparency Rules.

**7.4** Another area on which I would like to comment concerns the interests of pension scheme members. The Group, as sponsor employer, needs to ensure that where elected directors are trustees, they are competent and clear as to their responsibilities to the schemes, and take appropriate advice given that some of the difficult issues which the Group has to confront may have implications for employer covenants and the funding status of the schemes.

**7.5** I would also like to draw the findings and recommendations of this Review to the attention of HM Treasury, the Department of Business, and their respective Ministers. In the course of this Review it has become clear that co-operatives and non-financial mutuals of a certain size and complexity need an appropriate regulatory regime. I would expect the Financial Conduct Authority under its new powers will wish to consider whether there are areas that in due course require fuller investigation.

**7.6** A further point that I feel obliged to make to members is this: because of the losses exposed last year and their severe impact on the Group's balance sheet, the high level of debt now carried by the Group has made it inevitable that the bank syndicates providing this funding will, for quite obvious reasons, continue to take the closest interest in the Group making rapid progress to strengthen its governance. Elected members need to understand that while autonomy and independence are cherished principles of co-operation, the harsh truth is that bad governance results directly in such autonomy being strictly curtailed. To put it at its simplest, with its current schedule of debt repayment, the Group does not have freedom of action on the proceeds of the disposals it makes. That is yet another compelling reason for putting in place a properly skilled and experienced Board at the earliest opportunity to regain some of the independence of action that has already been lost.

**7.7** What will happen if elected members refuse to take resolute action and do not adopt the implementation plan set out in Chapter 6 and instead deliberately opt for what they see as modest, incremental change at a far slower pace than I have argued is necessary? While this may seem justifiable to some, on the basis that "*the co-operative way is to sit down and talk it over for as long as is necessary*", I strongly believe that such an approach would provide false comfort for elected members and would gravely harm the Group's long term ability to survive and the true interests of its several million ordinary members, its employees and its pension scheme holders. Among the top ten grocers, for example, there is likely to be no organisation more challenged by the price war now developing in food retailing unless the Group can swiftly put a strong, well-informed Board in place.

**7.8** Without decisive commitment to rapid reform, the banks may well have their own view on the appropriate timetable for transition to a new governance structure. In those circumstances, my concern is that that the Board's and Executive's discretion may become increasingly more constrained, with portfolio decisions progressively forced on the Group by its creditors. The consequential risk is an erosion of scale economies, further pressure on margins, an inability to pursue valued social goals, and the ultimate risk of an accelerating decline into irrelevance.

**7.9** I have not explored the possible consequences of such a head-in-the-sand mentality. My Terms of Reference are quite precise. I have not been invited to review strategy. Nevertheless, it is only right that I offer a brief comment on the situation that would arise if, looking ahead, elected members do not show the appetite or discipline to govern the businesses that they own far more responsibly than at present. Under such a scenario the Board and NMC could seriously consider disposing of all these businesses to create a tax-exempt charitable foundation that would fund the Group's social purposes. The act of doing this could create tax implications and it could also accelerate pension issues and crystallise lease obligations. Nevertheless, this would be the logical response if the Board were to conclude that none of its businesses address unmet needs or is run in a radically different way from commercially owned competitors. If the Group cannot govern its businesses to the same standard as those with whom it competes, it would make more sense to put these businesses into the ownership of others who could more effectively create value than it is able itself to achieve. But before any such an exercise could even be contemplated, there might need to be acceptance that the value of the foundation could be a lot less than many people currently imagine. I would be personally sad if that happened, but it would probably produce a better outcome than continuing with today's governance practices.

# Appendices

# Appendix 1

## Terms of reference

On 11th December 2013, The Co-operative Group Board appointed Paul Myners as Senior Independent Director with immediate effect. He is leading the comprehensive independent review of the Group's governance, aiming to create a co-operative which has best in class structures and working practices fit for its scale and complexity and able to demonstrate true accountability to its membership and wider stakeholders. At a meeting of the Board on 14 January the following Terms of Reference were approved.

The purpose of this forward-looking review is to:

- Review governance arrangements of the Group, with particular emphasis on evaluating the effectiveness of the Group Board and ensuring the interests of the entire membership are properly served.
- Examine the structure, board policies and working practices of the Group Board, including its size and composition, the functioning and composition of its committees, its interface with management and involvement in strategy setting, its information flows, the extent and effectiveness of its delegation, monitoring and control arrangements, and the governance of the Group's relationships with affiliated bodies and representative organisations. The review will also consider board and senior management expenses and policies for ensuring adherence to fiduciary responsibilities and for effectively dealing with conflicts of interest
- Make proposals on Group Board structure, including the proportion of independent professional non-executive directors, to strengthen the balance of knowledge, skills and experience on the Board. Consider the case for appointing executives to the Board
- Consider the manner in which independent co-operative societies are represented in the Group's governance structure and implications arising from the Group's role as a retail society with its role as a secondary Co-op for those independent societies
- Ensure the robustness and integrity of all governing structures and procedures, specifically:
  - reviewing the nominations and appointment processes, remuneration practices and performance of Board members, drawing on established best practice in good governance
  - ensuring appropriately skilled Board members lead the Sub-Committees to provide appropriate scrutiny, rigour and accountability
  - ensuring all Board decisions are taken in the appropriate manner, with access to all relevant facts, and after due deliberation and challenge; ensuring also that these decisions are properly recorded and supported by a best practice company secretariat function
  - ensuring adherence to the highest standards of probity in all Board and individual Board member dealings
- Examine the organisation's relationship with its entire membership base, consider the cost of membership governance, and develop recommendations for connecting more effectively with members, their interests and what they value and want from their

membership. To ensure the Group is acting responsibly toward all stakeholders, consider how best to achieve proportionate, transparent and timely engagement with members, customers and employees

– Evaluate best practices in governance, including from other co-operatives and mutuals, and assess their appropriateness for inclusion in the Group's future governance arrangements

**Process**

The review is being conducted in two phases.

In **Phase 1**, the primary focus will be on assessing the effectiveness of the Group Board and its interaction with management. In view of the urgent need to put in place a Group Board structure that is fit for purpose in providing appropriate guidance and support to management in a period of fundamental restructuring of the business, it is envisaged that initial proposals for changes to the Society's Rules will be put forward at the next AGM in May 2014. A Special General Meeting to approve changes to the Rules is expected to be convened in the third quarter of 2014.

**Phase 2** of the independent review will examine the governance options for strengthening connectedness with members, and evaluate the most effective ways of engaging with customers and employees including through electronic media. Recommendations will be developed and discussed through a full consultation process that provides opportunities for all members to voice their opinions.

The Phase 1 report will be produced by April 2014. It is envisaged that the Final Report and recommendations will be completed in late 2014.

The independent review welcomes suggestions and input from all those with an interest in the good governance and future of the Group. The address for comments is Myners.Review@co-operative.coop.

# Appendix 2

# Group Board effectiveness analysis

## Introduction

This is a review of the governance arrangements of the Group, with particular emphasis on the effectiveness of the current Group Board. It is based on interviews with Group Board members, Subsidiary Board IPNEDs and professional advisers and employees along with the Review team's observation of a series of Group Board, committee and Subsidiary Board meetings and the review of board papers, agendas, terms of reference, training material and other relevant documents.

While this is an analysis of the current Group Board's effectiveness, many of the issues described stem from systemic problems with the Group's governance. They have been in existence for some time and will endure despite changes to individual board member(s) unless fundamental reform is adopted. Where this is the case, this analysis tries to highlight the root cause along with the impact it has on current Board effectiveness. This review should be read in conjunction with the full Report.

The analysis is divided into two sections, based on the Review's terms of reference. Section A provides a detailed look at four elements of board effectiveness: size and composition, collective capabilities, roles and board dynamics. An understanding of these elements is critical to the recommendations made in Chapter 5 of this Report. Section B includes a more cursory evaluation of three elements: governance bodies and delegation, monitoring and controls and board support, all of which need to be addressed but are of a secondary importance in terms of the Review's recommendations. Each element concludes with a series of recommendations. The "main" recommendations have been integrated into Chapter 5 of this Report, the others are supplementary.

## SECTION A

### 1. Composition

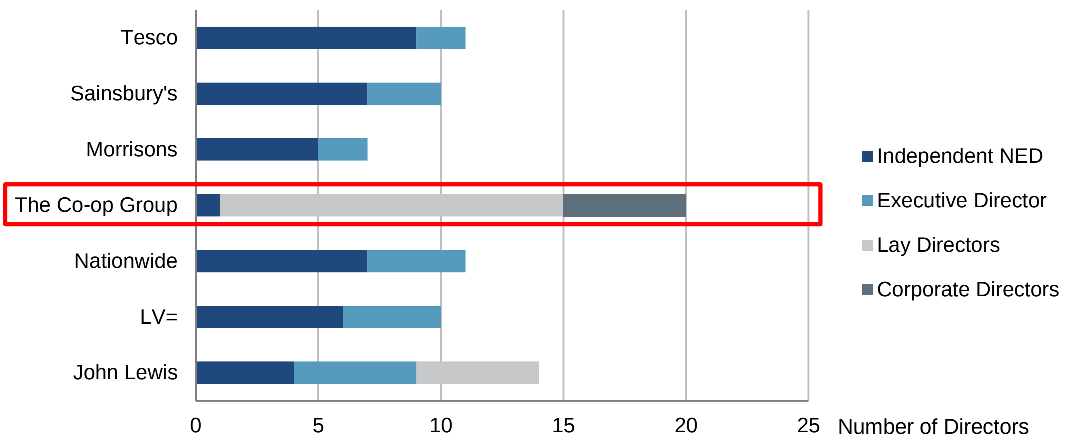
#### 1.1 Size

The current Group Board has 21 seats, 20 of which are currently filled. The issue of size has been raised in previous reviews, including the most recent internal review in 2012, and is recognised by most Board members to be a problem. However, due to the current representational nature of the Board, the number of members has remained high. Extensive research suggests that when a board becomes larger than 12, its effectiveness starts to diminish. A board of 21 is too large for meaningful debate or effective decision-making. Its cohesiveness is undermined because board members are less likely to share a common purpose, communicate with each other clearly or reach a consensus that builds on the directors' different points of view. In addition, director 'free-riding' increases because the cost to any individual director of not exercising diligence is inversely related to board size.

All of these undesired outcomes exist for the Group Board. As described below, the constituency nature of its membership creates misaligned priorities and these are exacerbated by the size. The Group Board struggles to hold conversations in which directors are able to build on each others' contributions, challenge assumptions and priorities and build a consensus. More usual is a series of bilateral exchanges which move from topic to topic without clear closure, agreement and/or next steps. In terms of individual accountabilities, many Board members are openly dependent on their fellow directors to carry out the Board's core roles and this is particularly the case for financial and commercial scrutiny and contribution. If the Group Board had fewer members this tendency to free ride would be removed – each director's contribution would become vital and any over dependence on others would quickly become obvious and problematic.

Exhibit A shows the relatively large size of the Group Board compared to its food retail and mutually-owned peers.

**Exhibit A – Peer comparison - Board size and composition***




* Excludes Company Secretaries
Source: Peer websites as at 14 February 2014

## 1.2 Membership

The current Board consists of 15 elected "lay members" from the Regions and five Corporate directors who represent the Independent Society Members. Currently, all five are the chief executives of their societies but this does not have to be the case. The Board can appoint three IPNEDs to fill skills gaps but only one of these spaces is currently filled. No executives are members of the Group Board.

It is important for the members of any board to establish collective accountability and this is particularly urgent for this Board given the Group's current challenging context of high debt and intense competition. The Group Board needs to make critical strategic decisions which will shape and drive the restructuring of the business and, once made, it needs to stand as one behind these decisions as they are implemented. However, the current membership configuration of the Board makes such collective accountability difficult, if not impossible. The different groups within the Board, along with the divided loyalties (described further in Section 3 below) prevent the Board from reaching a consensus view and acting in a way which is congruous with this.

*Lay directors*

The lay directors have strong allegiances to their Regional constituencies (as described in greater detail in Section 3.2 below). This results in divided loyalties and puts pressure on lay directors to act other than in a collective way in the best interests of the Group.

*Corporate directors*

There are tensions between the lay directors and the Corporate directors. While lay directors openly place a large amount of reliance upon the Corporate Directors for their business acumen and experience, they do not overwhelmingly support their presence on the Board. This view is reinforced by many at Regional board level who, in their submissions to this Review, expressed a lack of enthusiasm for having Corporate directors on the Board at all. Their concerns were centred on the fact that these directors come from competing organisations and an anxiety that they "*do not scrutinise properly as they are too close to the Executive*". There are particular concerns that the current Chair comes from an independent society and is too close to management. At the same time, Corporate Directors have commented on the low level of business capabilities possessed by some lay directors and describe how this can make Board meetings long, slow and frustrating.

*Executives not on the Board*

Finally, there has been well documented tension and mistrust between Board directors and Executives for many years. For example, the 2013 external review identified high levels of distrust and suspicion with the Board directors expressing a "*feeling of being outmanoeuvred*". The rift was reiterated during this Review. While there are several causes of this tension, including the massive disparity in capabilities (described in greater detail in Section 2.4 below), a number of lay directors are of the view that the agendas and motivations of Group Executives are and always will necessarily be at odds with those of the Board directors – "*They will always want different things, won't they?*" This supposition makes it difficult to establish mutual trust and respect between the Board and the Executive. Many organisations do appoint executives to their boards which means they take on the same directors' duties and responsibilities as their fellow board members. This establishes greater alignment on objectives and motivations for the two groups and thus decreases tension and suspicion and makes for a significantly more effective working relationship.

## 1.3 Tenure

Under the Rules, each Group Board director term is three years and members of the Group Board can hold office for three consecutive terms. However, agreement made during the 2007-2009 Constitutional Review to disregard service on the Group Board prior to the Annual General Meeting in 2009 has resulted in several Board members continuing to sit on the Board even though they have served more than three consecutive terms. The Review recommends putting directors up for re-election every three years by rotation and limiting tenure to six years with the possibility of a third term upon consent of the NMC, regardless of any further reconfigurations of the Group.

## 1.4 Diversity

Currently there are four women on the Group Board, including the Chair. While this is an improvement on some previous configurations, the current composition falls one person short of the Lord Davies' recommended 25 percent by 2015. The Group Board Diversity Policy has set an even more demanding Board Diversity Policy target of a minimum of 33 percent women on the Group Board by 2016 and a minimum of 40 percent by 2018. The current electoral system means there is little or no control over the gender (or other) diversity at the Group Board aside from the option to reserve Area Committee seats for ethnic minority members[1] and potential encouragement at grass roots level for

[1] The South East Region is the only Region to have introduced reserved seats for ethnic minority members (for North London and South London Area Committees only).

a diverse population to get involved in the democratic structures. By changing the nomination and election processes, the Group could put in place stronger measures to encourage and establish diversity on the Group Board and other bodies.

## 1.5 Time commitment

To be eligible for office, lay directors on the Group Board must concurrently occupy seats at Regional board and Area Committee level. Many also sit on Subsidiary Boards and committees and the boards of "sister" organisations such as Co-operatives UK and the Cooperative Press. Holding multiple offices in this way requires a high level of time commitment and the Review team has been told that attendance rates are very good. Some Board members cite as many as 72 days per year when they are required to be in attendance in their various governance roles. TCG's obligations alone are significantly more than the national average for an organisation of this size. In Review interviews, several Group Board members expressed a view that the time requirement is too onerous and some described how they have either had to give up their day jobs or curtail their other professional commitments to make time for the Group and its sister organisations. The commitment given by Board members in terms of attendance is strong. They can be removed from the Group Board by a majority resolution of the other directors if they are absent from three successive or, in any year, in excess of 50 percent of the Group Board meetings. However, there is a risk that high financial dependence on remuneration for governance positions could inappropriately influence or compromise decisions. For example, if the Board is asked to agree a decision which is in the best interests of the Group but threatens the sister organisation's stability and the viability of its governance position (e.g. a significant reduction in TCG funding), then the Board member involved will be placed in a position of conflict.

The demands on time for the Corporate directors are not as onerous but are still high, given these directors usually have full time roles managing their independent societies. A couple of Corporate directors described how they had to be "*persuaded*" or "*cajoled*" into taking the role due to the heavy demands on their time and that the time commitment had "*surpassed their worst expectations*".

### Board Recommendations – composition

**Main**

- Reduce Board size to a maximum of 10
- Appoint at least two executives to the Board
- Put Group Board directors up for triennial re-election by rotation

**Supplementary**

- Reduce the time commitment required for NEDs to closer to three days/month
- Take appropriate actions to aim for greater diversity including 25 percent female representation on the Board by 2015 in line with Lord Davies' recommendations
- Provide guidance to maintain independent status for Group Board members when taking leadership positions with other organisations

## 2. Collective capabilities

### 2.1 Election and appointment

The current election and appointment process for lay members has three fundamental flaws: it severely restricts the size of the pool of candidates standing for election to the Group Board; it provides no rigor around the capability levels of candidates; and it provides minimal scope to balance the capabilities and meet identified skill requirements.

To be eligible for election to the Group Board, candidates must have held office at Area Committee level for 24 months and on a Regional Board for a further 24 months while concurrently continuing on the Area Committee. Before becoming eligible to join the Area Committee, they need to have been a TCG member for 12 months. This three tier system means it takes a minimum of five years for a member to be eligible to stand for election to the Group Board. During this period they will have had to dedicate themselves to numerous elections as well as attending meetings for the Area Committee and the Regional Board. This is an onerous system designed to ensure those standing for election are true co-operators and to ward off "carpetbaggers" but one unwanted outcome is that it produces a tiny pool of individuals willing and able to stand for election to the Group Board. As one director stated, it has "*dissuaded individuals with skills but not time, particularly younger members, from seeking higher positions in the democratic hierarchy*". One Subsidiary Board IPNED told us that "*those with aptitude to acquire needed board competencies – such as corporate finance – would likely have pursued other interests than dedicating their lives to climbing the democratic ladder*", and another said, "*why spend 10 years wading through treacle – I wouldn't bother*".

In addition to the tenure requirements described above, candidates need to meet a qualification requirement prescribed by the Group Board Development Centre (this also applies to Corporate directors). The GBDC provides an interview and portfolio based process which was phased in between 2011 and 2013. The Review team understands that the principle of skills-based eligibility requirements has faced significant resistance in the past from elected members, many of whom believed that qualification requirements were "*barriers to the democratic process*". Prior to the GBDC there were no skills or experience requirements to stand for election.

In order to complete the GBDC, candidates are required to assemble a portfolio of evidence and attend various one-on-one meetings with an independent 'mentor' assigned by the GBDC. Each candidate must demonstrate ability in the seven competencies described in Exhibit B below.

**Exhibit B – Group Board Development Centre Competencies**

- **Competence 1 Strategic**

  Knowledge of the strategic development process in The Co-operative Group, understanding of the Group's strategic plans and the ability to implement strategy through decision-making

- **Competence 2 Financial**

  The ability to interpret and analyse financial information and utilise it to identify trends and monitor progress against budgets and objectives

- **Competence 3 Group Knowledge & Business Environment**

  Knowledge and understanding of key factors impacting on modern businesses, including the wider commercial and legal environment

– **Competence 4 Legal and Governance**

Understand the legal and governance framework within which both the Society and individual directors work

– **Competence 5 Values & Principles**

Understanding of and empathy with the Society's values and principles

– **Competence 6 Stakeholders**

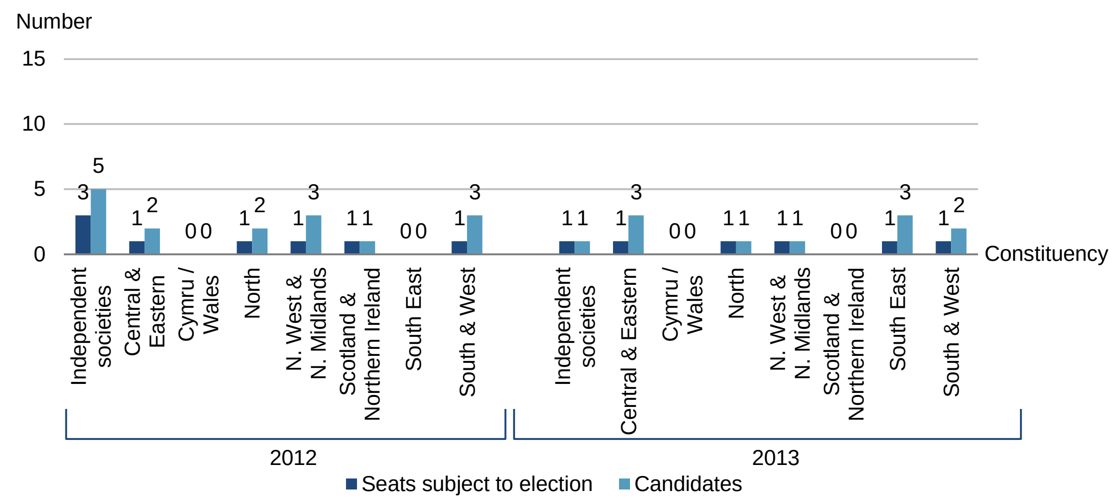
Knowledge of and empathy with the Society's stakeholders

– **Competence 7 Analytical**

The ability to analyse and understand information and proposals and to translate analysis into effective decision-making

In fact, very few Regional or independent society candidates have completed the GBDC. As at February 2014, only 35 otherwise eligible candidates, including all but four or five current Group Board members, had completed the GBDC and were thus eligible for election or re-election to the Board. This is a ridiculously small pool from which to choose members of the Board and severely restricts the quantity and quality of potential talent available. Exhibit C sets out the contestability of Group Board elections in 2012 and 2013. As one Regional director commented "*we get all sorts and often it is not a real election as there is only one credible candidate*".

## Exhibit C – Contestability of Group Board Elections 2012-2013




Source: TCG Membership Team Feb 2014

While the aim of the GBDC process is to guarantee a certain level of capability on the Group Board, the standard required to pass this assessment falls dramatically short of what would be expected of a Group Board Director for an organisation of the size and complexity of TCG. Exhibit D sets out example activities provided by the GBDC to illustrate the level required to achieve Competence 1. Similar descriptions are provided for the other six.

**Exhibit D – GBDC Competence 1 – Strategic**

| Description | Examples of activities at Regional Board |
|---|---|
| S1.1 Contribute to the implementation of membership strategy for the Society/region/area<br>S1.2 Demonstrate an understanding of The Co-operative Group's mission and vision and identify areas of strategic focus to achieve that vision<br>S1.3 Understand how strategic plans are developed in The Co-operative Group<br>S1.4 Contribute to the implementation and monitoring of business strategy through scrutiny of management performance e.g. monthly trading reports & requests for approval | – Involvement in the strategic planning cycle – attending presentations/briefings, engaging in board discussions, contributing to national V&P strategy<br>– Analysing the strategy for each of the businesses and contributing to the implementation of operational plans<br>– Using information provided to the board to monitor management performance against business strategy<br>– Promoting membership engagement through an understanding of the key aims of the Membership Strategy |

Source: TCG GBDC Qualification Structure 2013

The GBDC competency level is described by a representative of the GBDC as being "*what we could expect all Regional Board members to be able to achieve*". Group Board directors describe it as "*a nonsense of a system*", "*rudimentary*" and "*not difficult to get through – you just have to do what the teacher says*". Once the GBDC requirements have been met, there are no further competence eligibility criteria or checks for Board members.

To compound the issue of limited capabilities, lay Board members are elected by Area Committee members who have regard to diverse criteria and priorities when choosing their favoured candidates, the majority of which do not relate to commercial experience and ability and, increasingly do not relate to the broad TCG Values and Principles. Several Group Board veterans have noticed greater numbers of "*single-issue activists*" (those who focus most of their attention on one topic such as diversity or Fair Trade) with little or no business experience being elected to the Group Board: "*It is almost at the stage where if you say you are in the Co-op Party you won't get elected. There is much more support for those with more ethical or sustainability platforms*".

By comparison, Exhibit E below illustrates the type of experience that a recruit to one of TCG's competitor peers would need to demonstrate. This is based on relevant business and leadership experience and sets a considerably higher bar than that established by the GBDC.

**Exhibit E – Example NED specification**

Role: NED of FTSE100 or equivalent organisation

Requisite Experience

- Broad business experience with a strong strategic and commercial track record as a CEO or Executive Committee member in a leading FTSE company (or its equivalent)
- Excellent understanding and experience of financial reporting and UK regulations
- Independent character who is able to engage constructively and broadly around the board table, and to challenge appropriately and effectively

- Successful track record of dealing with the City, government departments, all political parties and the media
- Able to understand a high profile consumer business and how to interface effectively with customers, consumers and employees

Source: Leading Executive and Board Search Firm

Along with restricting the pool of potential candidates and failing to produce Group Board directors of sufficient capability, the current election system does little to create a balanced board which collectively possesses the requisite combination of skills and experience needed to govern TCG. The only mechanism available within the current election and appointment process to compensate for any skills gap is the option to appoint three IPNEDs to the Group Board. The IPNED category was introduced in 2001 but, to date, only one IPNED has been appointed, despite recognition from a number of Group Board members, (including formally in the 2012 Board self evaluation), that IPNEDs would be a valuable addition and would bring much needed skills.

The current approach to election and appointment makes it nearly impossible to put in place an effective board with the needed combination of skills and experience to govern TCG. It is responsible for the consistently deficient collective Group Board capabilities described further in Section 2.4 below.

## 2.2 Induction and development

Induction for new Group Board Directors is designed to take place over two to three days and covers TCG Values and Principles and Board processes. It includes sessions with key executives and the Group Secretary. New directors are "*free to talk to any managers thereafter*" and can observe committees and Subsidiary Boards. Feedback shows that induction has been a mixed experience for Board members. Some expressed satisfaction with the level of support, whereas others would have liked the opportunity for greater exposure to management in the different businesses. One of the Subsidiary Board IPNEDs described it as "*very light touch compared to other boards*" that they had experienced and another described it as "*very controlled – if you didn't know how to access the businesses directly then you might not find it easy to do*".

The Executive, Group Secretary and TCG Corporate Governance team are responsible for the ongoing training and development of Group Board directors once elected. The TCG Learning & Development Policy (LDP) sets out quite a comprehensive set of learning options for Group and Subsidiary Board directors. These include pre-Board meeting education evenings, round table discussions with senior management, mentoring and coaching and web-based learning programmes. It commits to put in place "*a robust process for assessing and prioritising learning and development activity*". At the Subsidiary Board level there is evidence of some effective training in the past, based on deep dives into the relevant businesses (see Exhibit F below). The Group Audit and Risk Committee has also received training, the most recent being Pensions Risk and Valuation (June 2013), Group Taxation Strategy (June 2013) and an IT deep dive (December 2013).

## Exhibit F– Summary of Group Board and Subsidiary Board Training 2012*

| | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov | Dec |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Group Board** | – | – | – | – | – | – | – | – | – | – | – | – |
| **Food Board** | Supply Chain (1.5hrs) | Own brand summary (1.5hrs) | Operations overview (1.5hrs) | – | Site visit (1.5hrs) | Local Ranging (1.5hrs) | Retail Location Analysis (1.5hrs)<br>Diversity training (2.5hrs) | – | Site visit (1.5hrs) | Christmas 2012 (1.5hrs)<br>Food finance (1.5hrs) | – | – |
| **Specialist Businesses Board** | Financial and operational KPIs (1.5hrs) | – | One to one vocal coaching for one member (5.5hrs) | Strategic update (1.5hrs)<br>Site visit (1.5hrs) | Visit to legal services (6 hrs)<br>Roundtable (1.5hrs) | PI landscape (1.5hrs) | E-stores (1.5hrs)<br>Diversity training (2.5hrs) | – | Customer care (1.5hrs) | CLS visit (3 hrs)<br>The new NHS (1.5hrs)<br>Site visit (3 hrs) | – | Branch transformation (1.5hrs) |

## Summary of Group Board and Subsidiary Board Training 2013*

| | Jan | Feb | Mar | Apr | May | Jun | Jul | Aug | Sep | Oct | Nov | Dec |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Group Board** | – | – | – | – | – | – | – | – | – | – | – | – |
| **Food Board** | – | – | Store visit (3 hrs) | – | – | Store visit (3 hrs) | – | – | – | – | – | – |
| **Specialist Businesses Board** | Customer Services (1.5 hrs) | Visit to Pharmacy Distribution Centre (6 hrs)<br>Strategic diversification (1.5 hrs) | – | Operating a successful crematorium (1.5 hrs)<br>Visit to Legal Services Operation (6 hrs) | Branch visit (6 hrs) | – | – | – | – | – | – | – |

Source: TCG Membership team

*This does not include induction sessions for new directors

However, formal development collectively and individually for Group Board members has been weak for a long time. There are occasional ad hoc requests made for support from the GBDC (e.g. for voice coaching and "*understanding accounts*") but some Board members are unaware of this option. The procedures set out in the LDP have not been followed on a consistent or regular basis. Moreover, over the past 12 months, the training programme has fallen away, even for the Subsidiary Boards, owing to the focus on recapitalisation of the Bank and other crises. One recently elected director described the development they have received as a Board member as "*non-existent*". Another said it was "*woefully weak*". This Review has found that training in commercial, financial and legal content has long been insufficient.

The LDP states that "*each NED shall have a personal development plan within 6 months of taking up office*". The Review team has found no evidence of the existence of these plans and thus concludes that they are not systematically put in place or reviewed annually as required by the policy.

## 2.3 Individual and collective evaluation

The Group Board has undergone a number of internal and external assessments and evaluations in the last few years.

| Date | Description |
|---|---|
| 2010 | External Review of Co-op Financial Services Board |
| 2010 | Group and subsidiary self assessments of board effectiveness |
| 2011 | Group Board peer evaluation round 1 |
| 2012 (May) | Group and subsidiary self assessments of board effectiveness |
| 2012 (Sept) | External Board Culture and Effectiveness Review |

In 2011 a Governance Working Group recommended an annual peer review. The aim was for one third of the Group Board members to complete peer evaluations and self assessments each year. Six were completed in 2011 however a number of Board members with whom the Review team spoke were unaware of this initiative and the Review team found no evidence of subsequent one-to-ones with the Chair or resultant objectives or feedback for Board members. As with the personal development plans described above, this may have happened for a proportion of Board members but has not been systematically established.

The 2012 external review included an examination of the relationship between the Board and the Executive, how the Board spends and prioritises its time and the respective roles of Subsidiary Boards and IPNEDs. While feedback was given, it is not thought that any work was done to act on the recommendations, despite serious concerns being raised.

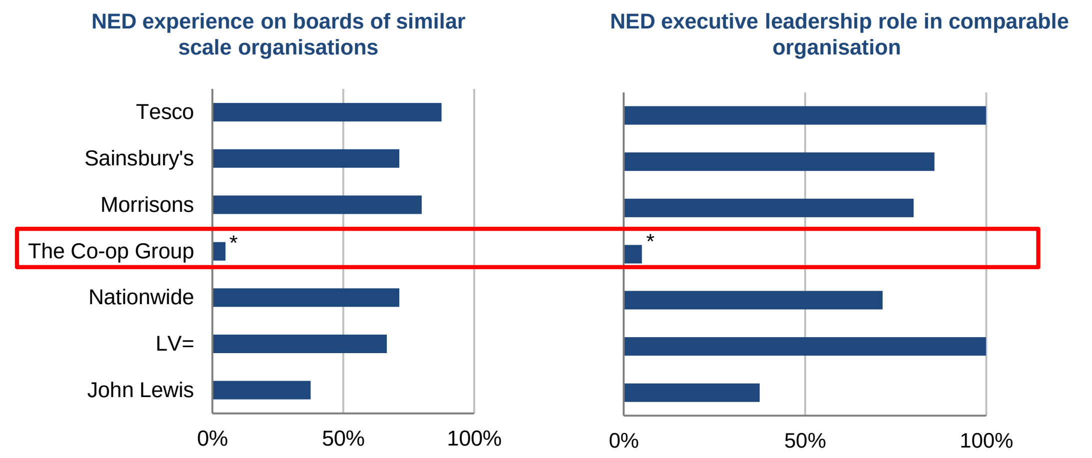
Despite being required under the Rules, no skills audit has yet been completed although the Review team understands the Board was on the verge of commissioning one before the start of this Review.

## 2.4 Knowledge, skills and experience

The Review team's assessment is that the current three tier election structure described in Section 2.1 combined with the inadequate eligibility requirements described in Section 2.2 have resulted in individual and collective skills of the current and previous Group Board being significantly weaker than those required for effective stewardship of TCG. The Review concludes that this has been the case for many years and has been exacerbated by inadequate training and development (as described in Section 2.3) but that would not, in itself, have rectified the situation.

There is a belief, expressed by many within the Group that any individual, given the correct training and development, will be able to effectively govern the Group, a belief which erroneously discounts the value of business and leadership experience. Exhibit G below illustrates the capabilities of Group Board directors relative to their peers using two measures as a proxy – experience on the boards of similar scale organisations and leadership roles in comparable organisations by size (turnover and number of employees) and complexity. It shows the massive disparity between the Group Board capabilities and those of its peers.

**Exhibit G – Peer Comparison – NED experience**




* Paul Myners
Source: Peer websites as at 14 February 2014

Examples of the manifestation of weak individual and collective capabilities include the following:

– *Lack of commercial acumen*: The lay directors lack fundamental business skills and struggle to understand TCG's businesses. When asked about potential ways to overcome the strategic and commercial challenges facing TCG they draw on personal anecdotes and cite co-operative values, neither of which contributes effectively to challenge, strategy formulation or decision-making. The Review team has observed lay directors struggling when presented with detailed operational and financial performance figures. The Corporate directors do bring business experience and skills but are able to compensate only in part, because the independent societies that they represent are far smaller than TCG.

– *Inadequate financial skills*: Many lay Board members have little understanding of financial issues and appear content to rely on the accountants on the Board although none of those accountants have had experience in an organisation of the size and facing the complex financial challenges faced by TCG.

– *Insufficient ability to analyse*: Lay Board members are frequently unable to analyse and interpret the content and implications of the information with which they are provided or to question its quality, robustness and completeness. Many describe the information they receive as "*too complex*" and several express a desire for the Executive to produce one or two page summaries to lay out the complex issues more simply. The Review team has observed repeated requests from the Chair in board meetings for information to be presented "*simply and briefly*". However the Review team believes that many of the issues that the Board face are just too complex to be simplified into the short notes requested and require much more sophisticated analysis and interpretation. Without such competence, the quality of conversation that the Board can have is severely limited.

– *Poor decision-making*: There is evidence of decision-making based on misunderstandings or ignorance of facts (see also Section 4.3 below). For example, the Review team has observed a lack of clarity about the value of TCG's asset base, confusion around trends in market share of the food business, and ignorance about the relationship between TCG and CRTG.

– *Over dependence on others*: The commercial capability deficit means Group Board members are forced into a position of over dependence on management and on external advisers to guide their analysis of risk and decision-making. Lay members repeatedly describe how the Board has relied on and trusted management (and their advisers) in the past and that this reliance is still inevitable.

– *Tensions with management*: The huge gap in understanding between the Board and the Executive creates tension and impedes challenge and decision-making. It also precludes the Group Board from playing the highly valuable role of mentoring, guiding and encouraging the Group management, a crucial role which effective NEDs play in other organisations, described further in Section 4.4 below.

In summary, the Group Board has inadequate commercial competencies to enable it to deal with complex business issues effectively. The Review team has seen evidence that suggests this has been the case for many years and will continue unless radical changes are made to the way governance is structured.

Furthermore, the capability gap is so large that it cannot be filled by training and development for the existing members and/or the addition of a few IPNEDs. The Board needs a complete overhaul of membership if it is to lead and govern an organisation capable of competing with its peers.

## Board Recommendations – Collective capabilities

**Main**

- Appoint all new members to the Board on merit against clear criteria of skills and experience, using TCG's competitor peers as a reference point for quality of commercial acumen, combined with affinity to TCG Values and Principles. Abolish the three tier tenure based eligibility requirements

- Establish a nominations committee which can identify the skills and experience needed on the Board, prepare a description of the capabilities needed, openly advertise positions and recommend candidates thus providing a quality threshold and a mechanism to balance board member skills, experience, independence and knowledge according to need

- Put in place a rigorous and systematic induction which includes Values and Principles, director duties and a thorough understanding of TCG businesses and markets

- Hold annual evaluations for the Board and each individual director and use the output of these to shape the nominations strategy and any programme of Board development

- Provide a programme of development for the Board, tailored according to individual and collective need and likely to include regulatory and financial developments, deep dives into TCG businesses and work on team dynamics and contribution

## 3. Roles

### 3.1 Role of the Group Board

The board of an organisation is ultimately responsible for its performance because it is responsible for hiring, monitoring, supporting and, when necessary, removing the management team. While a board may not automatically deserve blame for specific management mistakes and misjudgements, recurring strategic errors and monitoring failures, as has been the case at TCG, suggest that the Group Board is as at fault as the management. This level of board responsibility and accountability is, in general, not accepted by TCG's lay directors. There is a strong tendency for them to blame management for all the organisation's failures and to fail to understand the role that the Group Board has played in allowing this management behaviour to occur.

### 3.2 Collective responsibility

As described in Section 1.1 above, the size of the Board impedes its ability to adopt collective responsibility. An even stronger factor is the three tier route that lay Board members take to reach the Board and the competing accountabilities that they juggle once they are elected.

English law and TCG's Rules oblige all Group Board directors to act in the best interests of the Society. However, many lay members also feel a need to be accountable to the electoral hierarchy who have the power to keep them in office or remove them. These two sets of accountabilities can conflict with each other which creates divided loyalties and insufficient shared purpose. The tension is particularly acute when hard decisions need to be made.

Lay directors frequently focus on the narrow issues of their local constituencies rather than the priorities for the Group as a whole. One director described how the Regional boards see their Board directors as delegates to represent the interests of the Region rather than the Group as a whole. "*They [the Regional Boards] direct them on what questions to ask and how to vote*" which "*results in a large amount of local self-interest*" and a weak sense of collective responsibility. Different Regions and, by extension, their Group Board members, have a range of different priorities and "pet topics". One independent director described how "*some want a dividend, some want low prices, some want to do social good and some want free range chickens*". This loyalty to constituencies leads to multiple objectives and, as one Board member expressed "*the Board is not focused on the right things and has so many sub agendas that it is a depressing experience when there is so much to do*".

When the best interests of the Group differ from a Region's interest, lay directors find themselves torn between acting in the best interests of their Region or the best interests of the Group and this affects the contributions made and the conclusions reached. Board members describe how "*taking bad news back to the regions when they need to be re-elected is hard" and "there is a lot of pressure on the elected members to disown Group Board decisions and maintain that they were not in favour of them*".

In addition, lay directors express that they are not mandated to make a decision until they have spoken to their Region which, at best, slows down the decision-making process and, at worst, results in previously made Board decisions being reversed or challenged by Board members at a later date when they have taken instruction from their Regional Boards.

Finally, the most dramatic impact of such divided loyalty, is seen in the series of 'leaks' which have occurred recently and sporadically for a number of years, whereby a member(s) of the Group Board has knowingly shared confidential information with others in the Regional Boards, sister organisations and the media, despite such actions clearly being contrary to the best interests of the Group.

## 3.3 Conflicts of interest

There is a general fiduciary duty on directors of all co-operatives to avoid conflicting interests and duties, with any conflict that does exist resolved in favour of the Society. The current TCG governance structures create a number of conflicts which need to be addressed urgently.

The challenge is most pronounced for the Corporate directors. In many cases, the business activities of their independent societies overlap and therefore compete with the Group. In addition many of the Independent Society Members are highly dependent on the Group's buying power to remain price competitive. Such potential for conflicts of interest means that Corporate directors might in principle oppose any decision by the Group that would diminish the collective buying power of the Co-operative Retail Trading Group (e.g. if the Group were to exit a sector), bring the Group into greater competition with their societies (e.g. through geographic expansion) or reduce their ability to compete (e.g. a national promotion that they are unable to match). As one Corporate director described it "*there are massive complexities around being a NED on a competitor and franchisor*".

There are inconsistent provisions regarding conflicts and independent societies in the Rules. While Rule 6.1 clearly calls for five members of the Group Board to be representatives of Independent Society Members, Rule 6.14 appears to give the Group Secretary the discretion to require a Group Board member to stand down if they are interested in a business that competes with the Group.

The Review believes that the inherent conflicts concerning these Corporate directors are extremely difficult to manage and their presence on the Group Board is no longer appropriate.

Lay directors also find themselves with conflicting interests above and beyond the allegiances to Regional boards described in Section 3.1 above. Several of the lay Board members are also on the boards of sister organisations which are funded by TCG e.g. Co-operatives UK and The Co-operative Press. This creates a risk that director decisions will be made in line with the best interests of the sister organisations rather than the Group. An example is a decision to reduce funding for a sister organisation in the best financial interests of the Group. Group Board Directors who also hold office on the sister organisation would be conflicted. Submissions to the Review website also raised concerns on this point arguing that these directors have the potential to influence funding decisions and to '*cash in*' on their positions on the Board.

Rule 6.46-6.49 and the Conflicts of Interest Policy contain protocols for declaring and managing conflicts but these are minimal. First, the Board must keep a register of interests and directors must disclose their interests (and declare them when relevant, even if already on the register). When a conflict is declared, non-interested directors decide whether an interested director can attend a meeting (and speak and/or vote) in relation to the matter. Second, the Code of Conduct also adds that Directors must not profit at the expense of the Group and requires declarations of interest to be recorded in the minutes. The Review team understands that the register is maintained (although it has not been provided to the Review) but the other systems and processes are not followed at all or are followed in a very "*amateurish*" way. Potential conflicts of interest are not always raised during Board and Subsidiary Board meetings and, if raised, are frequently then ostensibly ignored in the ensuing conversation. One director described in interview how "*there are so many rules that people just move on*".

**Recommendations – Competing roles**

**Main**

- Clarify the legal duties and accountabilities of Group Board members and of the Group Board collectively
- Review and enforce rigorous processes around conflicts of interest
- Cease to include independent society directors on the Group Board

**Supplementary**

- Use strong chairing to encourage collective responsibility for the Board to act in the best interests of the Society

## 4. Board dynamics

### 4.1 Quality of conversation and challenge

The Board has a history of poor challenge. Veteran Group Board members describe how there has never been much challenge on the Board – "*it is for rubber stamping – always has been*". Another commented "*under previous management, challenge was not encouraged*". When Board members lack the skills and knowledge to understand the content of Executive presentations it is highly unlikely for them to then properly challenge at anything beyond a superficial level. The Review team has observed that lay directors generally find it difficult to challenge assumptions, scrutinise conclusions or offer alternate implications for consideration. In addition, they appear to feel they need management's permission to challenge them.

The factors described in previous sections (size, capabilities and competing roles) result in a very poor overall quality of conversation and directors themselves describe Board interactions as "*dysfunctional*" and "*not fit for purpose*". One Subsidiary Board IPNED described how, at a Subsidiary Board meeting "*the level of debate was so poor and mundane I felt sorry for the management team*". At Board meetings there is some reasonable questioning from Group Board members, particularly the Corporate directors, about the core issues being tabled. There are also a large number of ineffectual questions about non-priority topics and anecdotal comments. These serve as a distraction, take up valuable time and do not frequently contribute positively to the quality of the debate or decision-making. Strong emotions are exhibited, including appeals to values made in contradiction to or absence of business evidence and rationale, and personal rebukes made by Group Board members to each other and to members of the Executive team.

In the Subsidiary Boards the Review team has observed a marked difference between the "professional" board members and the others. IPNEDs contribute thoughts on strategic or commercial implications and draw on their own business backgrounds whereas lay directors spend much of the meetings asking basic clarifying questions and making comments which are marginally or not relevant.

Lay Board members describe how, by relating their personal view on commercial matters under discussion they are playing their role to the full and making a valuable contribution of informing strategy with the voice of the membership and consumer. However, there are more effective ways of conveying member and consumer perspectives at the Board e.g. through the regular presentation of statistically robust, focused member and consumer research.

Given their limited capabilities and experience, Group Board members do, as one Subsidiary Board IPNED described "*find it difficult to articulate their views and be confident*". There appears to be a culture of expressing views and concerns individually outside of the boardroom and then not speaking up or following others in the board meeting itself. One adviser explained how a number of board members had come to him individually expressing concern about transactions that the organisation was entering into but did not feel confident enough to express this at the board table so their concerns were not raised.

## 4.2 Prioritisation and focus

Section 3 above describes how Regional allegiances result in multiple agendas and priorities. This manifests itself in a Board which finds it difficult to focus and spend enough time on business matters and for which commercial issues are often a secondary consideration. Conversation tends to be dominated by regional and local issues and niche Values and Principles matters rather than critical commercial and strategic Group issues. One director describes how "*We don't prioritise: we need to be commercial and sustainable. We need to do less, better*". Another described how "*the focus of the board is very poor – wrong things are on the agenda and the quality of debate is skin deep*".

| Exhibit H – Rules setting out role of the Group Board |
|---|
| – Deciding the vision and strategy of the Society and its businesses in consultation with the Subsidiary Boards, and having regard to the nature and extent of its interest in all of its businesses |
| – Ensuring, whether directly or through other people, that the Society's businesses and affairs are conducted and managed in accordance with its Purpose and Objects, and in accordance with the best interests of the Society and its Individual Members and Independent Society Members |
| – Monitoring the Society's businesses |
| – Overseeing the Group Chief Executive and the other members of the Executive as they carry out their roles |

Source: TCG Rule 2.10

Under TCG's Rules, the Board should be focusing its time on the four areas described in Exhibit H. In reality it has put insufficient focus on three of these: deciding strategy, monitoring the businesses and overseeing the Executive. While much time in meetings is spent discussing the second, whether the businesses are being managed in accordance with the Society's Values and Principles, this does not appear to be done in a rigorous or holistic way and, as described above, the conversation often strays to minutiae and anecdote or to local issues. The result is that the Group Board does not spend its time on the most essential issues, but has very long and laborious board meetings discussing non-priority issues with scant output in terms of decisions and next steps.

### 4.3 Quality of decision-making

Group Board decision-making can be extraordinarily slow and cumbersome and is often of poor quality. There is a history of decisions being taken slowly (or not at all) then, once taken, being reversed or ignored. Some Board members will describe how decisions were often made with their "*backs against the wall*" without an acknowledgement of the need to make the best decision possible in the time available.

Through interviews and observation the Review has uncovered several drivers of this behaviour:

– The lack of adequate commercial capabilities as described in Section 2.4 above mean that Group Board members are unable to understand the highly complex decisions and supporting information with which they are confronted and either stall or ask for more information, both of which consume precious time.

– The lack of business experience means Board members are typically uncomfortable taking decisions quickly with incomplete information. In such a fast-moving business environment, it is necessary for them to be comfortable with making assumptions and taking decisions with an element of uncertainty but this is a difficult thing to do and requires experience, judgment and confidence.

– Some decisions, such as the disposal of the farms business, have a high emotional element for Group Board members and their Regional constituencies and have historically resulted in decisions being unmade or left to the last minute.

– The three-tier election cycle also slows down decision-making – lay directors need to get an opinion from the Regions before they can condone a course of action and sometimes the Regions then need to consult with their Area Committees.

– Despite efforts made to furnish the Group Board with the requested information, the poor quality of management information over the past few years means there have been many misunderstandings of the fact base. This has resulted in decisions being made, based on the wrong information. Examples that the Review has encountered since the start of the Review include an overvaluation of the Group's net assets, an overestimation of the contribution from fruit farms to the overall farm business and an uncertainty about the market share and relative position of the food business.

### 4.4 Interface with management

The Review team understands that the relationship between the members of the Board and the management team has historically been poor although there is some agreement that relationships have improved significantly since the arrival of the current management team.

Previous board reviews, including the external review of 2012, describe relationships full of suspicion and mistrust and, in their interviews with the Review team, Board members described how, in the past, they have been bullied and ridiculed by Executives. The significant disparity of commercial knowledge and experience between the two groups has contributed to frustration and mistrust. As one director stated "*it is human nature if you don't understand something to be suspicious*".

Board members have a crude notion of "control" in relation to the Executive, describing how the Executive team is there to do what the Board says. This interpretation of the relationship does not include any of the nuances which exist in other board/executive relationships around influencing, guiding, supporting, encouraging or working together as described in Exhibit I below.

**Exhibit I – Guiding role of NEDs**

In addition to monitoring performance and driving effective risk management, the best NEDs play a valuable role of providing executive members of the board with direction, guidance and support.

Being an executive can be a lonely job with few people to turn to for candid and thoughtful advice. For CEOs and their teams, one of the most valuable and valued roles that the chair and other NEDs can play is to act as a sounding board and provide counsel, mentorship and encouragement.

To do this well, NEDs must possess the perspective, judgement and wisdom that can only be built up from personal experience and allows them to suggest novel solutions and provide fresh perspectives. Their wisdom and experience makes them good listeners and positions them to encourage and motivate executives. When executives encounter tough situations, effective NEDs are able to both provide practical advice and to listen and coach the executives to reach stronger solutions and maintain morale.

For this to work, the relationships between NEDs and executives on a board clearly need to be underpinned by trust and mutual respect.

Board members place a high degree of blame on past management for the Group's failures and describe how the Board was not listened to and was pushed into making decisions that they were not happy with or did not have the full information to make. They describe a situation where they have been unable to stand up to management and challenge them. At the same time they have little insight into their own failure to exercise proper oversight of the management team and stand up to them or, if necessary, remove them from office as they are entitled to do. There is very little sense among Group Board members, even those with long tenure, of their own accountability for poor performance and scarce acknowledgement that a stronger, more capable board, would not have allowed management such latitude thus forcing the Group into its current challenging situation.

## 4.5 Chairing

The chair of the Group Board can be either a lay director or a Corporate director. The current chair is the latter which has caused concern among some of the lay directors who think the chair is "*too close to management*" and therefore not independent and "*does not understand the Group well enough*". While the current chair was chosen by her fellow directors, the Review understands that she was the only candidate when the previous chair resigned. Some Board members have expressed the view that the nomination and election processes were insufficiently rigorous.

Interviews conducted during the Review revealed that effective chairing of the Group Board has long been a challenge with one Board member declaring "*chairing has always been poor – there has been a fundamental inability to lead*".

The Review observed that the Chair was efficient at moving the meeting along and giving everyone a chance to speak. However, there was little synthesis of contribution or directional guidance, nor was there effective facilitation or debate to move divergent views towards a consensus. The Review team understands this to be the cultural norm for the Group. To be effective, both inside and outside board meetings, a chair needs to play a broad role which incorporates the following elements:

- Be a source of wise counsel to the CEO, providing credible advice based on years of experience while respecting executive responsibility
- Create the right board environment for high quality debate and decision-making
- Manage dynamics so that contentious or 'difficult' issues are raised and addressed
- Challenge and hold executives to account as needed
- Uphold highest levels of corporate governance
- Interface effectively with a range of external and internal stakeholders

**Board Recommendations – Board dynamics**

**Main**

- As above, put in place a Board with significantly enhanced capabilities, able to govern such a large complex organisation including the hiring, monitoring, supporting and if necessary removal of the management team
- Appoint an independent experienced Chair

**Supplementary**

- Introduce NED only sessions of the Board either before or after each meeting, as an opportunity for NEDs to discuss matters of concern and which relate to the Executive
- Include an assessment of dynamics and quality of conversation and challenge in regular Board evaluations
- Adopt practices to prevent backtracking on decision-making by individual Board members e.g. formal votes, minuting individual agreements, strong chairing

## SECTION B

### 5. Governance bodies

The multitude of governance bodies with overlapping responsibilities has resulted in blurred lines of authority and diminished accountability for the Group Board.

### 5.1 Regional Boards

Regional Board responsibilities and accountabilities are laid out in the Rules and Regional Regulations and are divided into those relating to 'the operation of the Society's democratic structures' and those relating to the Society's business. Both of these aspects can create blurred accountabilities and have an impact on the functioning of the Group Board. First, as described above in Section 3, the Regional boards have a huge influence over the behaviour of their elected representatives on the Group Board, including the questions they ask and how they should vote on individual issues. This is problematic as it compromises the Group Board directors' duties to exercise independent judgement and act in the best interests of the Group.

The roles and responsibilities relating to the Society's business include the right to receive and monitor trading information at a Regional level and the Scheme of Delegation (which has not been updated since 2011) sets out approval rights of certain management proposals including those relating to certain capital expenditure matters and the closure of core trading units. Under this scheme, the Regional Boards must review any capital expenditure plans of over £5 million which relate to trading activity before the proposal is submitted to the Group Board. Anything between £100,000 and £250,000 must be approved by Regional Boards in addition to the relevant level of management. The Review team has been told that, in reality, the approval process is more of a consultative process than a decision-making one. Management describe it as a rubber stamping exercise as the Regional Boards very rarely oppose management's recommendations. TCG is run as a national business so even if the Regional Boards do have a contrary view, it is very hard for them to shape the national strategy.

## 5.2 Board committees

The committee terms of reference are adequate. However, in reality, the committees appear to have more power than is intended or is appropriate. Probably due to the commercial capability deficit on the Group Board and/or the lack of time, the Board typically just "*accepts*" what the committees decide because "*that's what you do*". One director remarked that "*I have never seen a Remuneration and Appointments Committee decision overturned*" and the situation is similar for the Group Audit and Risk Committee.

## 5.3 Subsidiaries

The Food and Specialist Businesses Subsidiary Boards were established as an outcome of the 2007-2009 Constitutional Review with the objective of improving the oversight of the subsidiary businesses and providing support to the overly large Board.

Some think the subsidiaries have improved oversight as originally planned. Others believe they "*get in the way*" and "*create confusion about how the different accountabilities relate together*" which has further blurred lines of authority. IPNEDs on the Subsidiary Boards express a frustration about receiving insufficient information to be able to contribute effectively to strategy development and raised the challenge of repetition with topics being discussed at the Subsidiary Boards and then again at the Group Board.

With the simplification of the business portfolio and implementation of measures to increase the capabilities of the Group Board, the Subsidiary Boards can be scaled back within the governance structure.

**Board Recommendations – Governance bodies**

**Main**

- Scale back Subsidiary Boards
- Put in place a revised and up to date scheme of delegation

**Supplementary**

- Review delegation of authority and terms of reference for Board Committees and establish an effective rhythm of committee reporting and questioning by the Group Board

## 6. Monitoring and controls

There are ineffective monitoring mechanisms and internal controls at many levels of the governance architecture.

### 6.1 Risk management

While risk management processes and registers are in place within TCG's businesses and at a consolidated level, the Review team understands that the discussion and management of risk at Board level has been weak for a long time. A review of available Board papers and agendas shows that board meetings have included little time for a structured discussion of risk with sparse opportunity to agree risk appetite, identify risks across the Group and consider and monitor mitigating actions. In an interview, one of the directors described how "*risk management is never considered properly by the Board*". Several Group Board directors were even unaware of the existence of a risk register.

Almost all the discussion of risk has happened at Group Audit and Risk Committee and, while minutes of these meetings are circulated, some Board members recognise that the Board has over-delegated to this committee. One adviser described how the '*Group Board usually skip through reports from the Group Audit and Risk Committee which are seen by many directors as "technical"*'.

### 6.2 Management information

Management information is weak, affecting both management of the business and the ability of the Board to understand and monitor performance, risk and the financial situation of the Group. There has been insufficient investment to support management information for many years and the current IT systems involve a myriad of applications and platforms which are not fully integrated. Consolidation is often manual and it can be very difficult to interrogate and flex data. This has compromised the quality and fullness of the information the Board receives.

### 6.3 Confidentiality and information sharing

The protocols and practices for sharing information with different groups in the governance structure are extremely opaque. The lack of control over the dissemination of information results in, at best, confusion over who needs to see and respond to what and, at worst, highly damaging leaks of confidential information. This needs clarification and enforcement as a matter of urgency.

### 6.4 Internal audit

From its limited review, the Review team understands that the internal audit function is not fit for purpose in terms of capabilities, information gathering, analysis and dissemination and prioritisation of topics. The Review has been told that an external evaluation has been launched to identify and rectify the weaknesses.

### Board Recommendations – Monitoring and controls

**Main**

- Put in place processes and policies to enable the Board and GARC to fulfil their respective roles

**Supplementary**

- Clarify the respective roles of the Board and GARC in relation to risk
- Invest in management information systems which can provide the data, forecasts and flexibility needed for high quality decision-making and risk management
- Design and implement a rigorous set of protocols for information dissemination
- Review and improve the internal audit function

## 7. Support

### 7.1 Secretariat and membership

Presently, there is a strict separation between the Corporate Governance team which supports the Group Board and the Membership department which supports the Regional Boards, Area Committees and wider membership. The Review has been told that the demarcation of roles is highly inefficient and this can create difficulties with respect to cascading information and sharing data.

### 7.2 Board papers and presentations

At the Board meetings the Review has observed, that Board papers have been of a reasonably high quality (although lacking consistent cover sheets and executive summaries), notes have been taken and individuals giving presentations have all been well prepared and have participated in an orderly way.

### 7.3 Agenda setting

As described above, agenda setting has not always focused on the most important topics leaving some priority topics to the end of very long meetings when Board members are likely to be too tired to give them proper focus. The recently instituted agenda structure with a session A for discussion and session B to note will help improve the focus of the Board.

### Board Recommendations – Support

**Main**

- Review role, responsibilities and structures of Secretariat, Corporate governance and Membership teams with a view to removing duplication and redundant activity and focusing on priorities

**Supplementary**

- Introduce consistent Board paper cover sheets which include a description of the action required by the Board and any impact on risk

# Appendix 3

# The ownership of organisations

The purpose of this paper[1] is to set out an account of what determines why certain types of ownership (plc's, mutuals and co-operatives) are more frequently found in certain sectors of an economy rather than others. It is useful to understand this because it helps to explain the relative competitive position of the co-operative ownership model over the course of time and across different sectors and, indeed, countries.

The approach summarised here is the one developed by economists over the last thirty years. This account is hugely indebted to the work of Henry Hansmann whose pathbreaking book, "The Ownership of Enterprise", is quoted liberally throughout this paper.[2] The analytical starting point is to define quite precisely what we mean by the concept of ownership, and then to examine the costs involved. This theoretical approach leads to the prediction that over time the lowest cost form of ownership will be- for reasons of efficiency – the one that tends to predominate.

To make this all much more concrete and specific, the rest of this paper addresses the following eight topics:

1. What are the different forms of ownership?

2. Where are they typically found?

3. What do we actually mean by "ownership"? What are its two key components?

4. What are the costs of market contracting?

5. What are the costs of ownership?

6. What predictions follow from this theory of ownership forms?

7. How does this theoretical framework apply to TCG?

8. What is the significance of this analysis for the recommendations of this Review?

It is important to point out that this analytical approach to investigating corporate ownership models is fundamentally different from the approach frequently adopted by sociologists. They may place such a high value on certain intrinsic aspects of co-operation and self-help that they believe the co-operative organisational format should be applied everywhere possible as a superior organisational model to investor-owned businesses. However, the economists' approach, while normally ignoring these aspects, can certainly take into account the psychological benefits that individual consumers may derive from purchasing their retail goods from an organisation in which they have an ownership share: this benefit is simply added to other benefits and netted out against costs.

The fundamental difference between the standard economists' theory of what determines the predominant ownership form in any particular sector of the economy and the accounts given by some sociologists is that economists make specific predictions on where particular ownership models are most likely to be found. These are falsifiable predictions that can be empirically tested against the evidence. By contrast, sociologists typically do not put forward a predictive

[1] The author of this paper is Paul Coombes.
[2] Hansmann H., The Ownership of Enterprise, 1996.

theory, so their approach cannot be tested. Since it is in principle unfalsifiable, such an approach has fundamental weaknesses even if it is psychologically highly appealing to some individuals.

Let us now address the key questions.

1. **What are the different forms of ownership?**

   A business can be owned by a variety of different suppliers or purchasers of its services. These include investors, employees, suppliers of other input factors, or purchasers, as in the case of consumer co-operatives. It can also be owned by none of these, which is the case for non-profit organisations, though it should be noted here that the co-operative form is a 'for-profit' model.

2. **Where are co-operatives typically found?**

   The World Co-operative Monitor is a research exercise being undertaken by the International Co-operative Alliance in partnership with the European Research Institute on Co-operative and Social Enterprises (Euricse). In 2013 it published its World Co-operative Monitor bringing together worldwide data on co-operatives and mutuals with turnover above $100 million. It identified 1465 of these across 42 countries. If we focus on the top 300 co-operatives worldwide, their distribution by sector was as follows: Insurance co-operatives and mutuals 41 percent; Agriculture and food industries 28 percent; wholesale and retail: 21 percent; (sub-total: 90 percent) Banking and financial services 5 percent; Industry and utilities 3 percent; Health and social care 1 percent.

   Why are co-operative and mutuals so concentrated in just three sectors and why do they have such a low share of industry? To explore this we need to tackle the next question.

3. **What do we actually mean by "ownership"? What are its two key components?**

   For the purposes of this discussion, we need to define ownership very precisely. To quote at length from Henry Hansmann's classic account, "The Ownership of Enterprise", "*A firm's 'owners'… are those persons who share two formal rights: the right to control the firm and the right to appropriate the firm's profits, or residual earnings*".[3]

   "*The reference to "formal" rights in this definition is important. Formal control, for instance, does not necessarily mean effective control. In firms that are incorporated … including business corporations, cooperatives, nonprofits and mutual companies – formal control generally involves only the right to elect the firm's board of directors and to vote directly on a small set of fundamental issues, such as merger or dissolution of the firm. Nevertheless… there are often strong reasons for giving the formal rights of control to a particular class of persons even when those persons are not in a position to exercise that right very effectively*".

   Hansmann goes on to say that it will be helpful to have a term to comprise all persons who transact with a firm either as purchasers of the firm's products or as sellers to the firm of supplies, labour, or other factors of production. He refers to such persons, whether they are individuals or other firms – as the firm's 'patrons'.

   The next point to make about 'ownership' is this: economists often find it helpful for analytical purposes to view the firm as a nexus of contracts. It is important to make it clear that this has no implication for the way in which individual employees or customers are treated; it is a purely analytical device to assist clear thinking. Some of these contracts are with suppliers of capital, labour and so on; some are with purchasers.

[3] All quotes in this paper are drawn from Hansmann op.cit. (pp. 11 – 49).

As Hansmann says, "*Broadly speaking each transaction that a firm enters into is embedded in one or the other of two relationships between the firm and the patron who is the other party to the transaction. In the first of these relationships, which I shall call 'market contracting', the patron deals with the firm only through contract and is not an owner. In the second, which I shall simply call 'ownership', the patron is… an owner of the firm.*"

Hansmann's theory is this: the lowest cost assignment of ownership will be that which minimizes the total costs of transactions between the firm and all its patrons. These costs fall into two categories: the costs of market contracting between the firm and its patrons, and the cost of ownership to any one class of patron.

We therefore now need to examine the nature of these costs.

4. **What are the costs of market contracting?**

The next piece of this argument is critical: there are several types of "market imperfections", or what are sometimes loosely called "market failures" whose costs, Hansmann points out, "*can potentially be reduced by assigning ownership to the affected patrons*". This is one of the two key factors that largely determine the most likely category of owner for a firm.

There are three particular examples of these market imperfections that owning a firm can help to overcome. These are:

**Simple market power**. If a firm has a dominant position *vis-a-vis* one or other group of its patrons, 'the patrons then have an incentive to own the firm and thereby avoid price exploitation'

**Ex-post market power ("Lock-In")**. A second problem of market imperfection can exist even in a market that is competitive at point of initial purchase. This occurs when the transaction between a patron and the firm is such that the transaction cannot be broken without considerable loss to the patron, and where the transaction locks the patron in for a considerable period of time. Life insurance and pension contracts are the obvious examples of this type of transaction.

**Asymmetric Information**. A further risk in market contracting arises 'where the firm has better information than its patrons concerning matters that bear importantly on transactions between them. In such circumstances, customers have an incentive to own the firm because that reduces the firm's incentives to exploit its customers.

There are other costs of market contracting, a number of which relate to issues involved in strategic bargaining between the firm and its patrons. However, the categories listed above are the key ones and sufficient to explain a good number of the reasons why the co-operative/mutual model of customer ownership arose as a viable and attractive economic model in the first place within certain sectors of the economy where these problems of market contracting were significant.

5. **What are the costs of ownership?**

If ownership were simply determined by identifying which group of patrons suffered the highest costs in market contracting, as Hansmann then argues, the determination of the most economic ownership patterns would be relatively simple. However, the second factor that needs to be brought into the equation is the relative cost of ownership. That is because the cost of ownership is not the same for all groups of patrons; some patrons have a far lower cost of ownership than others.

Why is this the case, and what do we mean by cost of ownership?

As Hansmann explains, 'ownership has two essential attributes: exercise of control and receipt of residual earnings. There are costs inherent in each of these attributes. Those costs fall conveniently into three broad categories: (a) the cost of controlling managers, (b) the costs of collective decision-making, and (c) the costs of risk bearing. All of these costs can vary substantially in magnitude from one class of patrons to another.'

Let us examine what Hansmann means by each of these costs.

5.1 **Costs of controlling managers**. This is essentially what academics call 'agency costs' and what is often popularly referred to as 'management capture'. Concern about these costs has been the primary driving motive for corporate governance reform in the UK and elsewhere over the last 25 years.

These costs can be broken down into two sub-categories: (a) the cost of monitoring the managers; and (b) the costs of the managerial opportunism that results from failure to monitor managers with perfect effectiveness.

(a) Monitoring costs: these involve (a) the costs of owners informing themselves about the operations of the firm; (b) the costs of communicating among themselves to exchange information and make decisions; (c) bringing these decisions to bear on the firm's management.

In effect, these costs depend on the importance, frequency and duration of the patron's transactions with the firm and the ease of organising any group of patrons for collective action. Such costs differ widely between groups of patrons.

(b) Managerial opportunism. The catch-phrase for this is the risk of 'stealing or shirking' i.e. the cost of straightforward corruption and self-dealing, and the separate cost of negligence and incompetence. In practice, the cost of fraud is typically a minor concern because there are plenty of legal and moral constraints on this. A far bigger problem is the cost associated with incompetent executive behaviour. This could take the form of empire building and unjustified expansion of the portfolio through acquisitions and mergers. It could also take the form of "reckless conservatism" i.e. under-investment and failing to take appropriate entrepreneurial measures to protect a firm's strategic position. Or it could just be waste and inefficiency in running the business.

5.2 **Cost of collective decision-making**. This is the second major cost of ownership. These may arise because of genuine differences of opinions over the best course of action to take to achieve a shared objective. But a more serious problem arises when the outcome of a decision will affect different owners differently or when owners have different objectives.

Where owners' interests are highly homogeneous, the costs of collective decision-making are correspondingly lower. This, in fact, turns out to be one of the contributory reasons why investor-owned firms have become so prevalent: there is typically a relatively higher homogeneity of interests between investors than is the case, for example, between employees. Of course, turning to TCG, there is the potential for a massive lack of homogeneity between the interests of the average member who shops in Co-operative stores, and the activist on a Regional Board, or the Group Board, who may have a vested interest in having funds available for distribution to his or her favourite causes, rather than using surplus funds for cash vouchers in retail outlets, or for dividends to several million members.

Where there is lack of homogeneity of owners' interests, there is a need to employ some form of collective choice mechanism, and the precise mechanism may be controversial. This has significance for understanding the situation at TCG: most TCG members will never vote; there are millions of them and as individuals they can have such little influence on the outcome that they engage in what has been called "rational apathy" or "rational ignorance". But the corollary of this is that it may well be the case that highly active members who spend a great deal of time working their way through the electoral hierarchy, have personal interests of their own i.e. vested interests, that are entirely different from the average interests of millions of non-voting members, given that turnout is typically well below 10 percent, so some 90 percent of members are non-voting.

So the costs of collective decision-making can be defined, in part, as those arising from heterogeneity of interests, especially where an unrepresentative minority is able to use control of the decision-making apparatus 'to make decisions that inefficiently exploit the majority in favour of the minority'

A further cost is that related to the time it takes, especially in a co-operative with lay board members, to explain the rationale for taking any particular decision. This can lead to endless procrastination and as a result the risk of missed opportunities.

Of course, one traditional argument of co-operators is that there is intrinsic value in the very process of collective discussion and decision-making. In effect, as Hansmann explains, it is a consumption good in its own right; it is also an education in civic participation. Yet, the reality within TCG is that this intrinsic value, however important, is only shared to any extent by some 600 elected members out of a membership of several millions.

5.3 **Cost of Risk-Bearing**. The third and final cost of ownership relates to the right to residual earnings. There are costs associated with this which affect different patrons differently in their role as potential owners For example, investor patrons can typically afford some considerable variability in their share of residual earnings. By contrast, the situation may be very different for consumer co-operatives because they have no access to pure equity risk capital beyond what they can accumulate themselves through generating surpluses and the typically small amount they can raise from their members.

Again, we see in the case of TCG how lack of access to equity capital markets means that the cost of risk-bearing is substantially higher than for other potential patrons such as investors.

We have now examined both the costs of market contracting and the costs of ownership. Just to summarise the theory, this argues that over time the owners of particular firms will tend to be the class of patrons who have the lowest relative cost of ownership combined with the lowest net cost of market contracting for all the other patrons of the firm.

6. **What predictions follow from this theory of ownership forms?**

**The first prediction is that as markets become more competitive, the cost of contracting will reduce.** This is because the disadvantages of not being the owner of a firm will be reduced i.e. there will be plenty of alternative providers of goods and services at competitive prices. This is of course what has progressively happened in UK retailing over the last 150 years. So this may well change the decision on which group of patrons is best placed to own a firm, with the emphasis now more exclusively on the costs of ownership rather than the costs of (ownership plus contracting). This is where investor owned firms have an advantage because of their typical homogeneity of owner interest (i.e. some formulation of ‘maximising profitability’). Because of their relative homogeneity of interests, investor-owned firms have comparatively low monitoring costs and collective decision-making costs. And, as we have seen, such owners have an advantage compared with other potential owners in terms of their ability to handle higher risk exposures. This is because they can raise fresh equity capital if they suffer unexpectedly high volatility of earnings.

**A second prediction is that regulation will also reduce the cost of contracting.** This is because it will act to reduce all three major elements of market contracting costs. First, it will reduce the risk of exposure to monopoly or monopsony pressures through imposing “competition rules”; second, it will reduce the risk of exposure to “lock-in” by specific product market regulation; third, it will reduce information asymmetry between owners and customers by imposing greater transparency and disclosure requirements on owners, and separately by creating regulatory controls to ensure product and service quality standards are met (e.g. the Food Standards Authority).

**A third prediction is that where a sector has a high demand for equity capital, it will tend to be dominated by investor- owned businesses.** This is because these businesses are best placed to access capital markets generally, and specifically can raise new equity without having to generate this through retained earnings. This decisive advantage enables them to be differentially able to bear the risk of volatility of earnings.

## 7. What are the specific implications for TCG?

The history of TCG and, in its former guise, CWS, has been 60 years of presiding over a substantial decline in its retail market share from a high point of some 20 percent at the end of the Second World War to a share of around 5 percent currently. While the competitive threat from multiple retailers was clearly recognised from the early 1950s, CWS found it extraordinarily difficult to mobilise an effective response. In part, this was because of the countervailing pressures described above:

– first, the intense desire on the part of federated consumer co-operative societies to retain their local autonomy and their reluctance to accept anything that they saw as diktats from CWS;

– second, an ongoing tendency for the elected lay boards of retail societies to be more interested in value distribution than in value creation, with funding of community related activities and other favoured causes ranking (for them) as higher priorities than disciplined building of the business and strengthening of the brand;

– thirdly, a resulting tension between the role of elected lay members at board level and the role of professional management, with an ongoing confusion about the meaning of democratic control.

In addition to these factors, however, we need to take into account the underlying forces that substantially determine the patterns of ownership that are likely to be successful in particular economic sectors. If we examine these in relation to the UK retail sector, adopting Hansmann’s analytical framework as described earlier in this note, this is the position that emerges:

## 7.1 Cost of market contracting – in the past

When the Co-operative movement was first established in the middle of the 19th Century, its ownership model had a number of powerful factors in its favour. In terms of market contracting these were:

– High cost of contracting with wholesale food/grocery distributors who often had monopolistic bargaining power

– Frequent lock-in, because of obligations to buy goods from employer provided stores

– Substantial information asymmetries with suppliers because of inability to assess quality standards of goods being purchased

In other words, UK retailing suffered from numerous market imperfections. This made it highly worthwhile for consumers to establish co-operative buying groups in order to achieve scale and thereby bargaining power in dealing with wholesalers. It also made it desirable in due course for federations of independent co-operative buying groups (i.e. societies) to establish their own secondary retail co-operative as a wholesale operation to avoid reliance on outside family controlled or investor owned wholesaling operations. That way, economies of scale could be achieved through the retail distribution chain, and quality standards could be safeguarded through the joint buying power of the federation and its expertise at the wholesale level in ensuring quality standards were met.

## 7.2 Costs of ownership – in the past

With these favourable factors at work in terms of the incentives to reduce high costs of market contracting, the second consideration was of course the cost of ownership. As we have seen, this has three components: the cost of monitoring, the cost of collective decision-making and the cost of risk-bearing.

– In the early days of the co-operatives, the cost of monitoring was relatively low because the operations of individual societies were relatively small and owner-co-operators were actively engaged in full time co-operative work; they were equivalent to family-run businesses, with whom indeed they were often competing. So they were not at an organisational disadvantage in monitoring performance.

– Similarly, in respect of costs of collective decision-making, in the early phase of co-operative growth, this was facilitated by the relative homogeneity of member interests, just as we see being typically the case with today's agricultural co-operatives.

– Finally, with regard to the costs of risk-bearing, again prior to the emergence of substantial publicly listed companies that could access equity capital markets, co-operatives were not at an automatic disadvantage to modestly sized retail competitors. Indeed, as the co-operative movement grew, they achieved comparatively advantageous scale economies compared with many competitors at both the retail and wholesale level. Thus, competition across the different levels of the retail market was right from the outset far greater than in some other markets such as, for example, Scandinavia.

Correspondingly, the co-operative ownership formula even in pure economic terms (and leaving out of consideration its distinctive social and ethical goals and values) had strong and sustained competitive advantages. Notwithstanding this, it is also worth noting that the progress of CWS was notably reliant on some exceptional leaders to build its position as an increasingly major supplier to consumer co-operative societies.

These economic factors thus explain a good part of the original economic success of the Co-operative Movement in the UK, though this is not to underestimate the significance of its wider social and ethical values and aspirations. It is important, however, to examine how far these factors remain relevant today. So let us now consider the current position in terms of the relative costs of market contracting and of ownership.

## 7.3 Cost of market contracting – today

The key points are these:

– The UK grocery retail market is highly competitive with a number of major rivals vying for market share right across the country. While temporary local monopolies may exist, the overall pattern is for an intensification of competitive forces across all size segments. Consumers do not typically face monopolistic sellers who can impose exploitative pricing.

– Similarly, there is no significant cost in terms of switching from one supplier to another, so there is no material 'lock-in'. Indeed, the efforts of large retailers are heavily directed to trying to buy loyalty through card schemes and other initiatives, rather than being in a position to impose it.

– Lastly, issues over food quality standards – a major concern in the past – have been largely dealt with through regulation such as the control environment exercised by the Food Standards Agency.

As a consequence, co-operatives in the UK have no automatic or guaranteed current advantage in terms of their ownership pattern enabling them to overcome otherwise high costs of market contracting.

## 7.4 Cost of ownership – today

Turning to the relative costs of ownership, in this case in comparison with their major rivals, investor owned businesses such as Tesco, Sainsbury's, Asda and Morrisons, there has been a substantial reduction in the original ownership advantages of the co-operative ownership model.

Let us examine this in relation to the key costs of ownership:

– Cost of monitoring: the problem here is one of scale and complexity. As CWS grew and eventually merged with CRS and then with United, it has become a massive food retailing operation in its own right (even without taking into account the other major businesses in its portfolio). Owner-management, on the analogy with the family-owned business, disappeared some generations ago. Instead, ownership became separated from management, with all the potential agency problems that can result from this, but made still more challenging by the very nature of the co-operative model, at least as widely interpreted by the main participants in the UK Cooperative world – the insistence on a particular definition of democratic member control. At the level of consumer co-operative societies, lay board members remained the rule, setting direction for their organisations, and frequently developing staff organically from within the Cooperative movement rather than recruiting from the wider pool of UK retailing expertise. Increasingly, however, effective monitoring became an insuperable challenge, and this was a major contributor to the massive decline in the number of individual consumer co-operatives from the 1950s onwards.

– The second cost of ownership is the cost of collective decision-making. Once again, with size and complexity, this became more problematic because individual societies inevitably had to develop more extensive election procedures to generate the lay member board leadership that this ownership model was deemed to require. As we saw earlier, these costs of collective decision-making are minimised when members' interests are highly aligned and homogeneous. However, the growth in the size of individual societies led to substantial divergence here between those members interested in active participation in the election process and related community engagement of the co-operative and the rest of the membership whose interests were overwhelmingly in buying good value products and services in a convenient way and at the lowest possible price. Since activist members have typically accounted for fewer than ten percent of members, this has led to a lack of automatic homogeneity between their interests and those of the majority of the membership.

– The third cost of ownership is the cost of risk-bearing. Again, this was an area where the Co-operative Movement was not at a serious disadvantage originally because of the relatively small size of its competitors. However, it now faces major world-class competitors in the form of public companies with substantial access to equity capital and an ability to withstand occasional earnings volatility and to out-invest in order to secure still further competitive advantage.

Thus on all counts – at least in terms of economic considerations – the UK co-operative ownership model can no longer demonstrate lower cost characteristics than the investor owned model.

## 7.5 The place of the social and ethical agenda

There is however a remaining factor that needs to be explicitly discussed, even though it is implicitly embedded in the economic analysis set out above. That is the social and ethical benefit perceived by members that derives from the co-operative model. This benefit has two dimensions: the value to Individual Members in terms of their personal participation; and secondly, the value to Individual Members in respect of their ability, as members, to contribute to the furtherance of their social and ethical goals.

The crucial question is what value members, on average, place on this social and ethical agenda, not in its own right, but in terms of the trade-off with members' preferences for better value and for cheaper, more competitive prices in TCG's food stores.

This is exactly where TCG arguably faces a serious democratic deficit. For while it is clear that there is a proportion of the membership that intensely values these social and ethical goals, and is willing to engage in voting in area elections, even on the most generous analysis the electoral turnout is below 10 percent of the membership, and on a more realistic analysis is well below 5 percent. So the core question of democratic control is the legitimacy of lay board member leadership of TCG when this does not explicitly represent some 90 to 95 percent of TCG members. In addition, the further question for consideration is the extent to which the distinctive benefits that accrue to senior positions within the elected hierarchy, at Regional Board level, and in particular at Group Board level, are tantamount to private benefits that are disproportionate to their position as members, and may unduly therefore influence their perspectives on the most appropriate form of governance for TCG in today's market conditions which are so fundamentally different from those that prevailed when the Co-operative Movement held a 20 percent share of the retail market.

### 7.6 What insights does this analysis offer on the recent history of TCG?

The starting point for this review of TCG's governance was the widespread recognition that TCG had suffered a massive governance failure in recent years, particularly evidenced by the near collapse of its banking subsidiary but also reflected in the substantially mishandled acquisition of Somerfield. Early analysis and interviewing, however, quickly revealed that in addition to these specific instances of governance failure, there were underlying, systemic weaknesses in the governance architecture that had been apparent over many years and that rendered the group particularly vulnerable from the time of the CWS/CRS merger. This was the occasion when, for the first time an integrated UK co-operative entity of this size and complexity changed from having a board of directors with a majority of operating executives, (with a measure of practical management experience) to a board which was controlled by elected lay members, most of whom had no business experience at all.

While this governance framework appeared to have been an expedient solution to securing the CWS/CRS merger on mutually acceptable terms, it created a hugely vulnerable control structure: this was a massive governance accident waiting to happen.

That this was not immediately apparent was, in the main, for two reasons. First, the arrival of a strong and effective chief executive, Martin Beaumont, who was able during his term as CEO to inject a substantial degree of new professional management into the newly combined group. Secondly, the continuing operational performance of the bank which effectively masked ongoing operational challenges in other parts of the portfolio and notably in the food business.

The merger with United in 2007, while theoretically a desirable step towards still greater integration of co-operative businesses in the UK and thus still further economies of scale, did not unfortunately tackle the intrinsic and dangerous weaknesses in the governance structure, despite a further extensive review between 2007 and 2009. Ideas that had been repeatedly proposed in the course of earlier reform initiatives, some going back to the time of the Gaitskell/Crosland review in 1955-57, and others dating from the Cooperative Commission in 2001, were once again raised and, after protracted discussion, buried. Such was the fate, for example, of proposals to bring on to the group board independent professional non-executives to make up for the skills gaps among lay members.

This last review was a deeply unfortunate missed chance, and its failure to address the inherent vulnerability of attempting to govern an organisation of considerable size and complexity with a board of non-executive lay persons was subsequently cruelly exposed in the near collapse of the bank and its majority disposal to hedge funds.

Regardless of the specific actions of individuals, both within and outside TCG, in connection with the failure of the bank, the fragility of the group's governance architecture made radical reform an urgent imperative.

## 8. What is the significance of this analysis for the recommendations of this Review?

If the analysis so far in this paper is accepted as providing both a convincing theoretical framework for understanding the pattern of different ownership forms within an economy, and for providing empirical evidence in support of this account, the final question is what this implies for the governance of TCG. Four implications are apparent:

8.1 The first point to make is that it is clear from this analysis that the co-operative form, at least as epitomised in the "majority lay board member" principle, is fundamentally unsound for an organisation of TCG's size and complexity. It has been a misguided attempt to graft onto original co-operative ownership models a new interpretation of democratic control that has manifestly failed at TCG. Looking ahead, it is essential that this lesson is learned. The principle of having a board of elected lay members to exercise 'democratic control' has failed on both counts: it has not provided truly legitimate democratic representation of eight million members with its extremely low electoral turnouts, nor has it achieved effective control of the business. The board took on unacceptable risks for an organisation with no access to equity capital markets. It then presided over a massive loss of its own capital base while increasing debt to unacceptably high levels that now impose the need for further asset disposals by the group. Blaming the former Executive team for these failures – whatever their culpability – does not excuse the group board from its own failure to monitor; this is exactly what a failure of governance means.

8.2 There remain further questions, of course, as to the ongoing prospects of the co-operative model as an effective ownership form for an organisation competing against investor owned businesses in the intensely competitive food retail business. This is a distinct issue of retail strategy that is outside the remit of this Review and is being addressed in TCG's current work on Strategy and Purpose.

8.3 Assuming permanent retention of the co-operative corporate form, the major implication that emerges from this is the need to ensure that the social and ethical agenda at TCG is appropriately integrated with the operational performance imperatives of the business portfolio and yet is kept clearly distinct from the governance requirements of running a large and complex business portfolio in an economically sustainable and successful manner.

8.4 A crucial implication of this is that the future governance architecture of the group should provide a separate organisational framework for the ongoing expression of those social and ethical aspirations and related community initiatives that most effectively match and respond to the interests and priorities of members as a whole. These initiatives, in turn, need to be pursued in a way that is economically affordable and that reinforces the success of the business and its reputation in individual localities.

The governance design that has the potential to meet these requirements is one that is based on a fundamental separation of current Group Board responsibilities. The first element in this is the need to create a fully professional group board, selected on merit that possesses the skills and experience to compete with its world-class rivals. The second element is the parallel need to create a new National Membership Council that will act as the guardian of the group's values with responsibilities for ensuring that its ongoing commitment to social and ethical goals is maintained and is translated effectively into specific local initiatives that build membership awareness and pride and that underscore the importance of a vibrant Co-operative presence in every community. It is the details of this governance design that we have set out in this Review.

# Appendix 4

## Distinctive features of the Co-operative Group's constitution

While many of the Co-operative Group's ("TCG") rules are distinctive by virtue of it being a co-operative society registered under the industrial and provident society acts, the table below sets out some of the most differential features of TCG's rules and, where possible, compares them with similar provisions found in the articles of association of a typical listed company (J Sainsbury plc) and the rules of a large building society (Nationwide Building Society).

| Provision | TCG | Sainsbury's | Nationwide |
|---|---|---|---|
| **RIGHTS OF MEMBERS** | | | |
| **Right to attend, speak and vote at general meetings** | Individual Members do not have the right to attend Society General Meetings. Instead, Individual Members and Independent Society Members are represented at society general meetings by a number of delegates (based on trade with TCG over the past year) from their Region or independent society. One Individual Member per Area in a Region may also join the Regional delegation as an observer (but cannot speak or vote).<br><br>TCG also has Regional Meetings for Individual Members registered in each Region, where the Individual Members have the opportunity to speak and vote on a one member, one vote basis. However, Regional Meetings are not meetings of the Society.<br><br>Voting by proxy is not permissible at Regional Meetings or Society General Meetings. Voting will either be by a show of hands (one delegate, one vote) or on a poll (weighted voting based on trade with TCG). | The holders of Ordinary Shares will be entitled in respect of their holding of such shares to receive notice of any general meeting of the Company and to attend and vote at any such general meeting. | Any member may attend and speak at a general meeting.<br><br>A 'qualified voting member' may vote at a general meeting and in a postal ballot on any resolution (other than one he is not eligible to vote on). A qualified voting member may appoint someone else (who need not be a member) as their proxy to attend, speak and vote on their behalf.<br><br>A member is a qualified voting member if they held either a requisite level of share investment or mortgage loan in the financial year before the voting date. |

| Provision | TCG | Sainsbury's | Nationwide |
|---|---|---|---|
| **Voting strength** | TCG employs a complex array of voting mechanisms in elections and at society general meetings. Notably, TCG has moved away from the traditional one member, one vote approach and employs purchases-based weighted voting in a variety of situations. Additional votes are calculated by reference to trade with certain TCG businesses over the past financial year.<br><br>Furthermore, the delegates for each Region or independent society will vote as a block. The Group's General Meeting Procedures and Standing Orders state that "Delegates shall vote in line with the Region's or Independent Society's agreed collective position". | At any general meeting, on a show of hands, every holder of Ordinary Shares present in person and every proxy present who has been duly appointed by a member entitled to vote on the resolution shall have one vote and every such holder present in person or by proxy shall upon a poll have one vote for every Ordinary Share of which they are the holder. | Qualified voting members are entitled to one vote whether on a show of hands or on a poll and irrespective of the number and value of their share investments and mortgage loans. |
| **Removal of members** | By following certain procedures, the Group Board may remove an Individual Member or an Independent Society Member from membership if: (a) TCG is unable to make contact with them (having taken reasonable steps to do so); (b) the member has purchased no goods or services from TCG in the past two years (individuals) / three years (independent societies); (c) the member has not added share capital to their account in the past two years (individuals) / three years (independent societies); (d) the member is demonstrably no longer committed to co-operative values and principles; or (e) on a complaint of conduct which is or could become injurious or detrimental to TCG. | By following certain procedures, the Company may sell any share held by a member (or any share to which a person is entitled) as a consequence of the death or bankruptcy of a member. A shareholder will cease to be a member if they forfeit or surrender their shares. | Membership ends automatically: upon death; (in the case of borrowing members) when a mortgage loan is repaid; or (in the case of investing members) a member ceases to hold a share investment. |

| Provision | TCG | Sainsbury's | Nationwide |
|---|---|---|---|
| **BOARD OF DIRECTORS** | | | |
| **Composition of the Board** | The composition of the Board is prescribed by TCG's rules. There are 15 seats reserved for directors elected by and from the Regions and five seats reserved for directors elected by and from the independent societies. In addition, the directors can appoint up to three independent professional non-executive directors. The CEO and CFO are not on the Board. | No fewer than two directors. There are currently 10 directors in office, including the CEO and CFO. | No fewer than eight directors. There are currently 11 directors in office, including the CEO and CFO.<br><br>Each director must hold a share investment to a value of not less than £1,000. |
| **Appointment and removal of directors** | The 15 directors representing Individual Members are elected for three-year terms. Individual Members cannot directly elect Group Board members. They elect Area Committee members who in turn will nominate and elect a set number of Group Board directors from a pool of eligible Regional Board members within their Region.<br><br>The five directors representing independent societies are also elected for three-year terms but through national elections. Under TCG's rules, directors, board secretaries, chief executives and senior managers of Independent Society Members are eligible to run for the Group Board.<br><br>The directors can appoint up to three independent professional non-executive directors, but their appointment shall be put to the next society general meeting for ratification.<br><br>There is no statutory or common law power applying to co-operative societies that would allow members (or the board) to remove directors from office – this is left to the rules. TCG's rules do not allow Individual Members, Independent Society Members, Regional Boards or Area Committees to remove directors – this | The directors shall have power to appoint any person to be a director at any time, either to fill a casual vacancy or as an additional director. Any director so appointed shall retire at the conclusion of the next following annual general meeting, and shall be eligible for re-appointment by Ordinary Shareholders at that meeting. Thereafter, directors shall retire by rotation at the annual general meeting on a tri-annual basis and be re-elected by Ordinary Shareholders. In practice, the Company must comply with the Corporate Governance Code that calls for the annual re-election of directors or explain why it does not.<br><br>In addition, the members may, by ordinary resolution of which special notice has been given, remove a director at any time (before expiration of their office) and may, by ordinary resolution, appoint another person in their stead. | The board may at any time appoint a director to fill a vacancy other than one arising from the retirement from office of a director at an annual general meeting. Any such director appointed by the board shall retire from office at the annual general meeting following their appointment and shall be eligible for election by members at that meeting without nomination or, if the director was appointed during the period starting with the beginning of the financial year and ending with the annual general meeting, at the annual general meeting in the financial year following their appointment. Thereafter, directors shall retire and stand for re-election by members at every third annual general meeting following their election. In practice, the society has voluntarily chosen to follow annual re-election of directors.<br><br>Any individual over 18 years of age and who is not prohibited by law from being a director may be nominated for election as a director by 250 qualified two-year members.<br><br>A director shall cease to hold office for one of a number of reasons, including if all other directors request, in writing, their resignation or if a resolution to that effect is passed at a general |

| Provision | TCG | Sainsbury's | Nationwide |
|---|---|---|---|
| | power is reserved to the Group Board in limited circumstances. | | meeting or on a postal ballot. |
| **OTHER** | | | |
| **Distribution of surplus assets following a dissolution or winding-up, after the satisfaction of all debts and liabilities, and the repayment of paid-up share capital** | Surplus assets shall be transferred to one or more societies which are: (a) registered as societies under the law; (b) in membership with Co-operatives UK; (c) have the same or similar Rule provisions as regards surplus distribution on a dissolution or winding-up as TCG; and (d) chosen by the those entitled to vote at a society general meeting.<br><br>Any assets not dealt with in this way shall be paid or transferred to Co-operatives UK, to be used and applied in accordance with co-operative values and principles. | After paying such sums as may be due in priority to the holders of any other class of shares in the capital of the Company, any further such amount will be paid to holders of the Ordinary Shares pro rata according to the amounts paid up or credited as paid up in respect of each Ordinary Share. | On dissolution or winding-up of the Society any surplus remaining after the Society's creditors have been paid and all share investments (other than deferred share (core capital) investments unless and to the extent provided in their terms of issue) have been repaid (according to any order of priority under the terms of issue):<br><br>– shall be paid in accordance with the instrument of dissolution (if any), but otherwise; and<br><br>– shall be divided among those investing members who have held share investments (other than deferred share investments) of at least £100 continuously for two years at the relevant date in proportion to the amount of their share investments at that date and those investing members who hold deferred share investments at the relevant date subject to, and in proportion to the amount specified in, or calculated by reference to, their terms of issue. |
| **Dispute resolution mechanism in rules or articles** | TCG's rules provide that certain disputes between "the Society or an officer of the Society on the one hand and an Individual Member… or Independent Society Member on the other hand" (or certain others which have ceased to be members within the last six months) if not resolved are to be referred to arbitration with a sole arbitrator appointed by Co-operatives UK, whose decision shall be final. | None. | Nationwide has an internal complaints procedure to resolve disputes with members. However, the rules state that any dispute which cannot be resolved may be referred to an ombudsman or any court with the relevant authority. |

# Appendix 5

# Duties of directors of co-operative societies under English law

This note is prepared for the purposes of being annexed to the independent Report prepared by Lord Myners and commissioned by the Board of Co-operative Group Limited ("TCG"). The note provides an overview of the key legal principles on directors' duties of co-operative societies under English law. It is for information purposes and does not constitute legal advice.

1. **Duties of directors of co-operative societies generally**

Directors of co-operative societies have a range of duties that derive from common law and equitable principles. They are fiduciary in nature, and import a duty of good faith.

By way of clarification, this note deals only with the duties of directors of co-operatives generally and directors on the main board of TCG specifically.

1.1 **To whom do directors of co-operative societies owe their duties?**

Directors of a co-operative owe their duties to the co-operative society itself.

Although directors of co-operatives may feel a certain affiliation with the members of the co-operative, or a particular section of them, their fiduciary duties as directors of the co-operative are not owed to the members, they are owed to the society itself. Directors with such an affiliation may set out the views of the members, but may not vote in accordance with those views if to do so would be contrary to the interests of the society itself.

Co-operative directors do not have a duty to act in the best interests of other stakeholders that are not members (e.g. customers, employees, suppliers etc.) per se, but on the basis that having regard to the best interests of stakeholders would be in the (medium/long term) best interests of the society and its members, it is certainly important for directors of co-operative societies to consider stakeholders' interests when carrying out their responsibilities.

1.2 **What are the key duties?**

Some of the key duties of the directors of co-operative societies are set out below.

(a) **Act in good faith in the best interests of the society and its members and act fairly having regard to all classes of members**

Directors of co-operatives must act in the best interests of the society having regard primarily to the interests of its members. Directors must balance long and short term interests and consider both present and future members. They should also bear in mind that the nature of a membership interest in a co-operative (like any mutual organisation) is primarily an interest as a customer or user of its services, and secondarily an interest as an owner. This is different from the nature of a member's interest in a company, and is an important factor in shaping the directors' duties.

Directors of a co-operative society must consider the interests of society members generally, and not just a section of them. This has the potential to give rise to a conflict between the interests of (i) the society and its members as a whole, and (ii) the interests of a specific part of the membership which may have elected a particular director. Any such conflict should be resolved in favour of the society and its members as a whole.

(b) **Exercise independent judgement**

This duty flows from the fiduciary duty to act in the best interests of the society and its members generally. It also overlaps with the duty of care. A director should be engaged and form his or her own judgement on the basis of all relevant information available to the director.

Any director who simply followed the directions of his or her own constituency or electing members would be in breach of this duty.

(c) **Exercise reasonable care and skill**

(i) Directors of co-operatives must exercise a reasonable level of care and skill. They should be diligent and responsible. They must be engaged and attentive, participate in meetings, ask questions and exercise their own judgement.

The general duty to exercise reasonable skill, care and diligence applies to all directors. However, the extent of the duty in practice, and whether or not it has been discharged, will depend on the specific facts of the case in question, including:

– the role of the particular director in question (in the specific context as a director of a co-operative society);

– the director’s status (including, for example, any remuneration package); and

– the natural expectations the members would have of the director.

The extent of the duty of a director of a co-operative society to exercise reasonable skill and care may differ in practice from the equivalent duty owed by the director of a building society or a company. It is important to focus on the context of the appointment of the directors of the co-operative in question, the nature of their election process and their appointment in the context of member control over the society.

Directors of a society registered as a bona fide co-operative society must at all times have regard to the relevant registration criteria and guidance published by the Financial Conduct Authority (“FCA”) for this type of organisation.

(ii) Requirement for the board as a whole to possess the whole range of necessary skills.

A board of directors should, between them, possess the appropriate range of necessary skills to meet the needs of the society. It is a matter for the board to consider and seek to address any significant skills shortages.

(d) **Avoid conflicts of interest and duty**

There is a general duty on directors of all co-operative societies to avoid conflicting interests and duties.

As outlined above, the position of a director of any co-operative may involve some inherent conflict between the director's loyalties to the society itself and to the members (or a section of them). Any conflict that does exist should be resolved in favour of the co-operative society. The particular society's rules are likely to include specific provisions about how conflicts should be dealt with and how interests should be declared.

(e) **Confidentiality**

Directors of a co-operative owe a strict duty of confidentiality to the society. This duty complements the duties to act in the best interests of the co-operative and to avoid conflicts. Any unauthorised disclosure of confidential information is likely to be a breach of duty.

(f) **Other duties**

A number of other general duties apply to the directors of co-operatives. These include duties:

- to act in accordance with the society's rules;
- not to make a secret profit;
- not to act for a collateral purpose;
- not to misapply the society's assets; and
- to advise in good faith, to inform and not to mislead.

2. **Some factors of specific relevance to the directors of Co-operative Group Limited**

Common law and equitable principles set out the foundations of directors' duties. There is also scope for a society's own constitutional and other related documents to fill in additional details. In the specific case of TCG, the Rules of TCG (the "Rules"), the Co-operative Group Board Code of Conduct ("Code of Conduct") and the Role Description & Person Specification for Group Board Members (together the "TCG Rules & Regulations") are of key importance in defining and interpreting the directors' duties. An individual director's letter of appointment setting out specific obligations and minimum time commitment expectations are also relevant to establishing what should be expected of the director. However, to a large extent, the TCG Rules & Regulations simply confirm the duties which the directors would in any event owe to the society as a matter of law.

Under the Rules, the board has non-delegable duties and responsibilities to ensure that TCG's business and affairs are conducted and managed in accordance with its purpose and objects, and in accordance with the best interests of the society and its Individual Members and Independent Society Members. This obligation to take into account the interests of members is echoed in the Code of Conduct, which provides that "Directors are required at all times to act in the best interest of the Society's members (current and future) having regard to the Society's Rules". We do not consider that these provisions alter the analysis about where the directors' duties are owed. We consider that these provisions articulate the content of the duty and whose interests have to be taken into account when the directors are exercising their fiduciary duties owed to TCG.

In relation specifically to the duty of care, the Code of Conduct requires directors to take "such care as a reasonable person would take in relation to their own affairs, as well as bringing to bear all relevant skills and experience that they may themselves possess". By itself, this provision could perhaps limit what may be expected of these directors. However, the Role Description & Person Specification point to much higher standards in terms of personal characteristics, skills and knowledge and relevant experience. The Role Description & Person Specification also sets out approximate time commitment expectations of board members.

Given the inherent conflicts that flow from the prescribed composition of the Group board, it would be helpful for the TCG Rules and Regulations to contain detailed and unambiguous provisions about how conflicts should be managed in practice. However, the TCG Rules & Regulations contain relatively minimal (and, in some respects, seemingly contradictory) provisions relating to conflicts of interest, and add little to the position at law, as outlined above.

## 3. Continuing obligations of the directors of TCG in respect of listed securities

As an issuer of listed debt securities, the directors of TCG must also comply with the relevant FCA Listing Rules ("Listing Rules"), Disclosure and Transparency Rules ("DTRs") and the obligations under the Financial Services and Markets Act 2000 ("FSMA") applicable to an issuer of listed securities.

### 3.1 The Listing Rules and the DTRs

The primary responsibility for ensuring compliance with TCG's regulatory obligations rests with TCG itself. If, however, the FCA considered that TCG had contravened any provision of the Listing Rules and that a person who was at the material time a director was knowingly concerned in that breach, it may take disciplinary action against that director or former director. The FCA may impose a financial penalty of any such amount as it considers appropriate, or may publish a statement censuring them. Similar, but slightly different, provisions would apply in relation to a breach of the DTRs. If a person discharging managerial responsibility (including a director) or a connected person has breached the DTRs, the FCA may either impose a financial penalty or publish a statement censuring that person. Also, if the FCA considers that a former director was knowingly concerned in a breach by the issuer, it may impose a financial penalty on him or her.

### 3.2 Market abuse

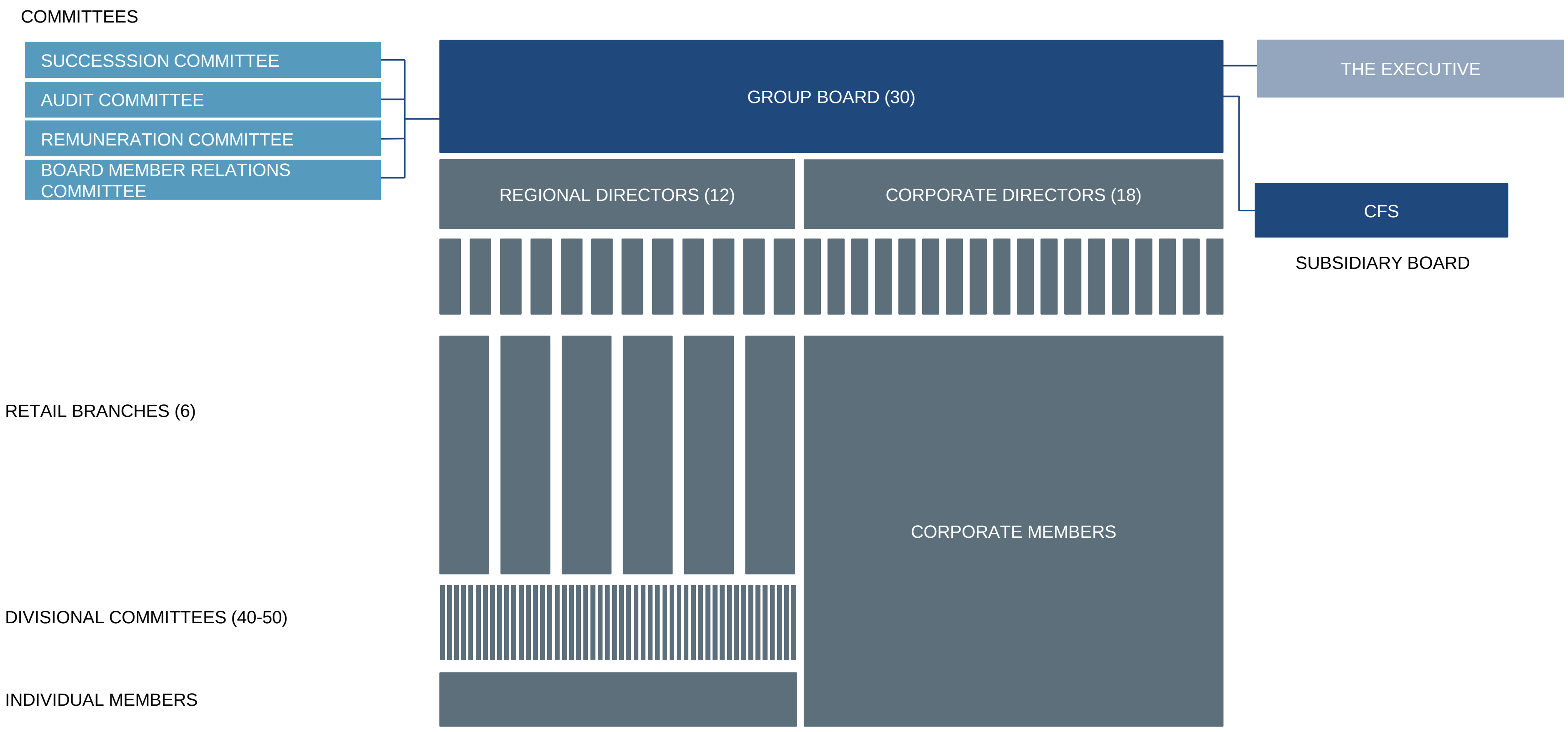
The market abuse regime under FSMA aims to prevent and punish behaviour which may have the effect of distorting the market. FSMA creates seven civil offences which can be committed by both individuals and corporate bodies that engage in certain behaviour, such as insider dealing, the improper disclosure of inside information, or disseminating false or misleading information, in relation to qualifying investments admitted to trading. As TCG's listed debt instruments amount to qualifying investments, the FCA would be able to impose an unlimited fine or publicly censure a TCG director who had engaged in market abuse. An injunction may be granted to restrain threatened or continued market abuse and a restitution order may be made in respect of any profits made or losses suffered as a result of the market abuse. Individual directors may also be criminally liable under the Criminal Justice Act 1993.

*The statements contained in this note provide a general summary of the legal position in England and Wales as at 7 May 2014, which may be subject to change. Accordingly, this note does not constitute and should not be construed as legal advice, or be relied upon as such. Neither Allen & Overy LLP nor any other member of the A&O Group: (a) owes or assumes any duty, liability or responsibility to any person who has access to the Report of the Independent Governance Review (or any part of it) for any information or opinion contained in it whether in contract, tort or otherwise; (b) makes any representation or warranty (express or implied) to any person as to the fairness, accuracy or completeness of the information and opinions contained in the Report of the Independent Governance Review or this note, whether at the date of its preparation or at any other time; and (c) shall be liable to any person for any loss arising directly or indirectly from any use of or reliance on the Report of the Independent Governance Review or this note or otherwise in connection with it. The A&O Group means Allen & Overy LLP, its subsidiaries and any other partnerships, corporations, undertakings or entities authorised to practise using the name 'Allen & Overy', and any of its partners, members, shareholders, employees, lawyers or consultants.*

# Appendix 6

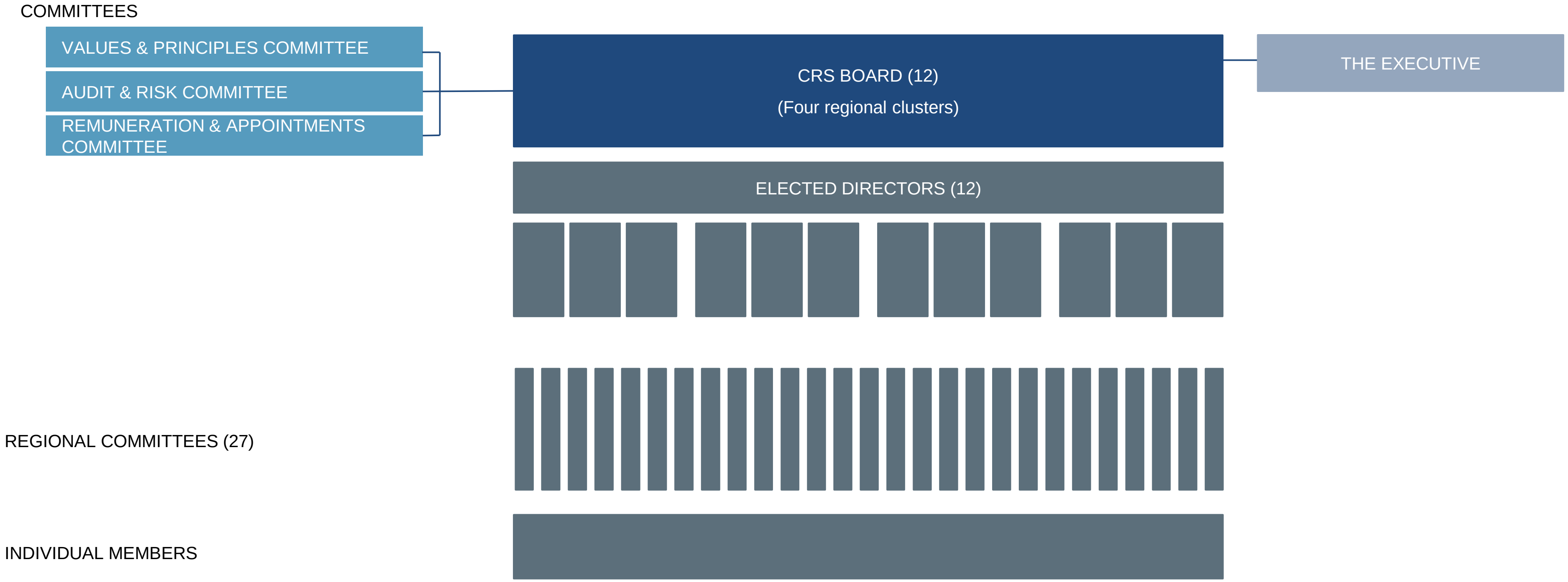
# Evolution of the Co-operative Group's governance structure

### Co-operative Wholesale Society (Pre-April 2001)



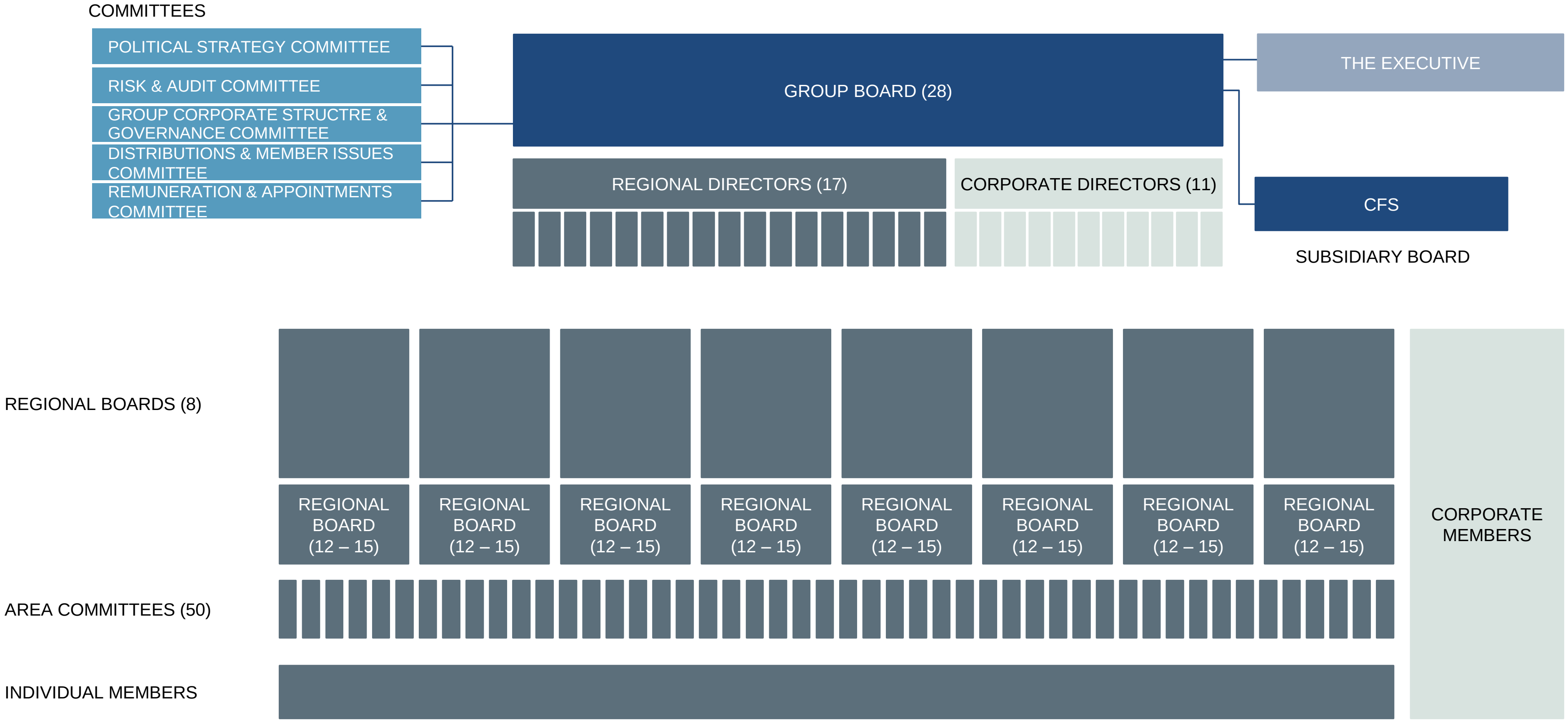

Source: TCG archive documents

## Co-operative Retail Services (Pre-April 2001)



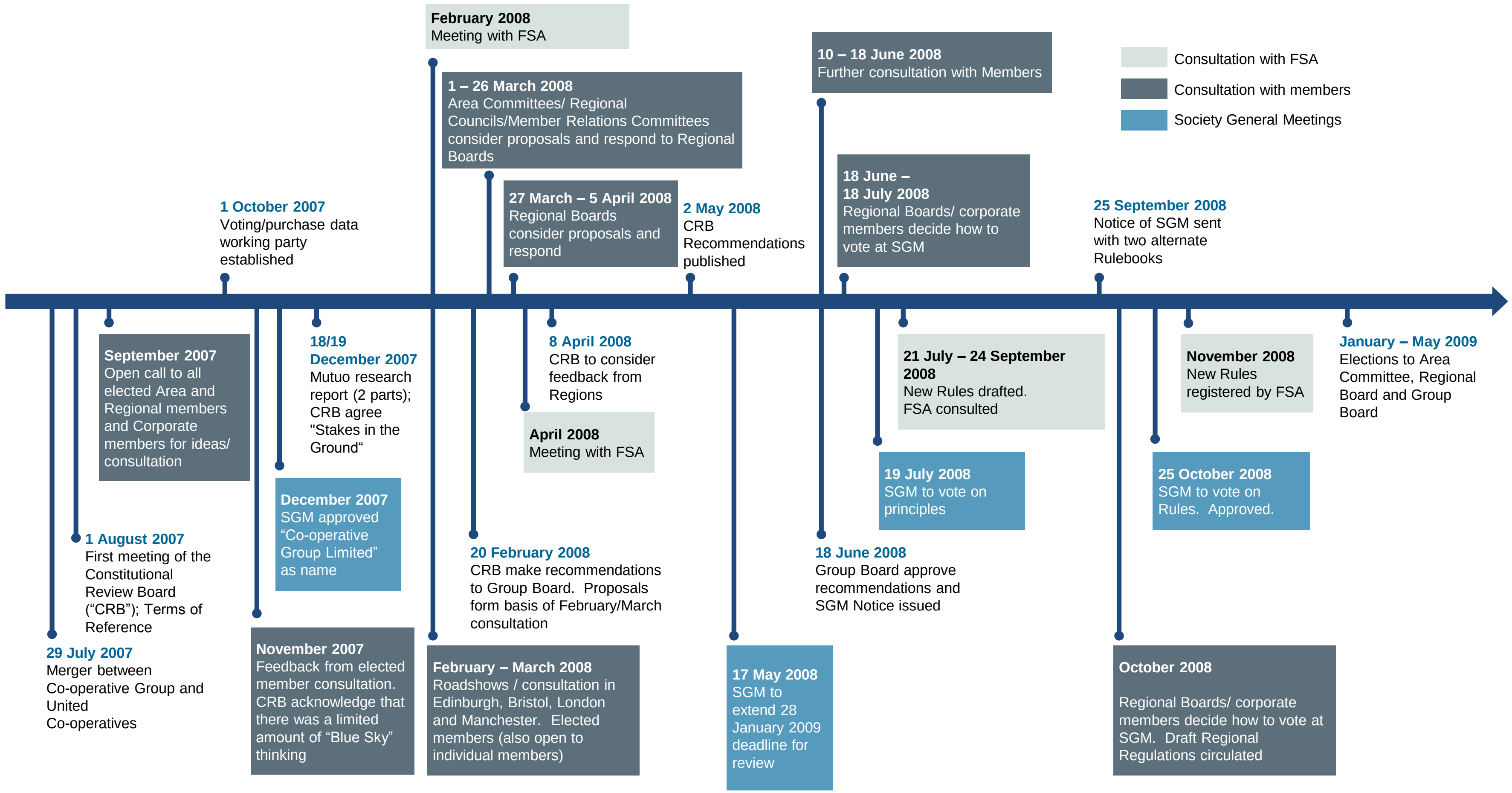

Source: TCG archive documents

## Co-operative Group (CWS) Limited (Post CWS-CRS merger (2001))



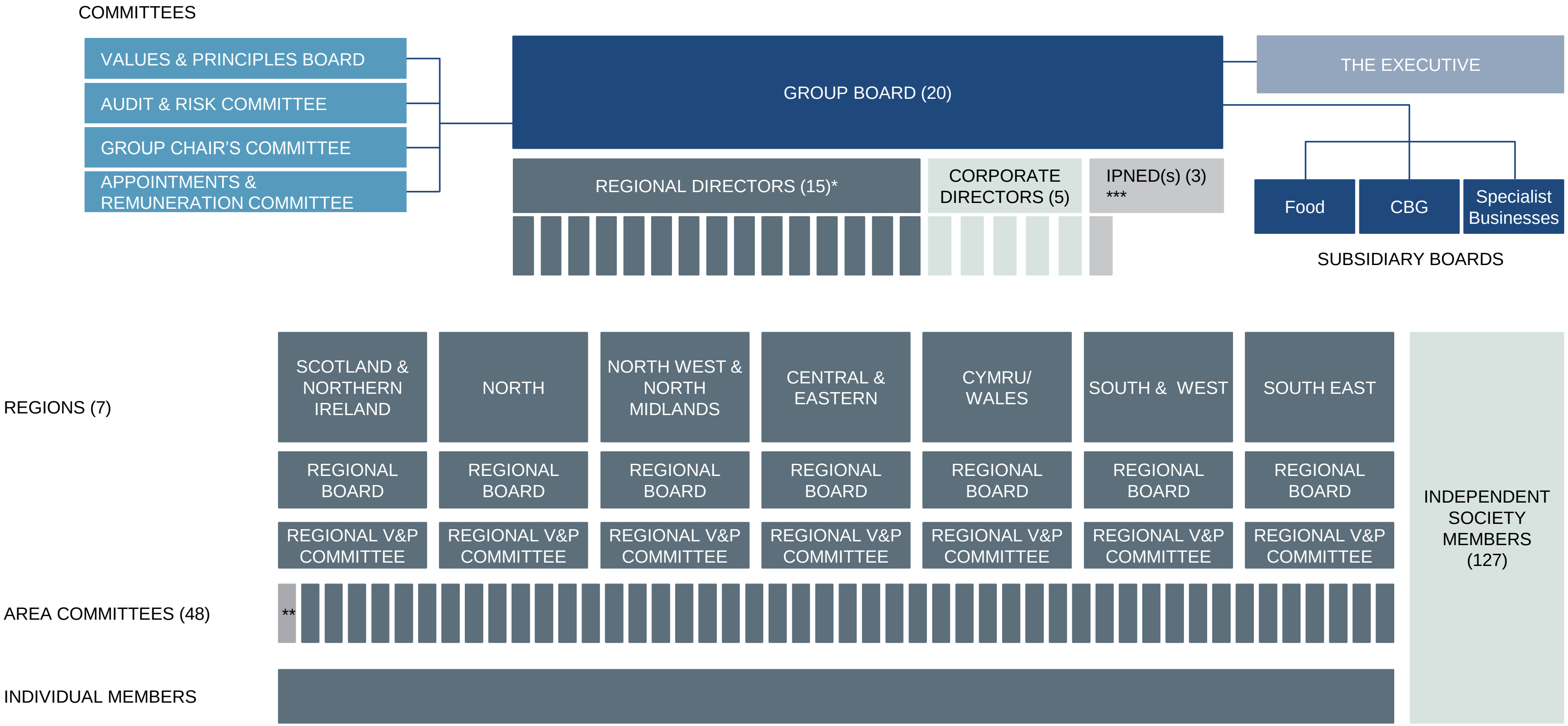

Source: TCG archive documents

## Timeline of 2007–2009 Constitutional Review




Source: 2007-2009 Constitutional Review archive documents

## The Co-operative Group (current structure)




*One seat is currently vacant
**Northern Ireland Members Council
***The Group Board may appoint up to three IPNEDs

Source: TCG's Rules and Regional Regulations

# Appendix 7

# The Co-operative Group electoral system

1. **Overview**

The electoral processes of the Co-operative Group Limited ("TCG") reflect the size and complexity of its governance structure. While the current arrangements are designed to encourage equitable representation and "churn" throughout the elected structures and member constituencies, the spectrum of different procedures and overlapping electoral cycles are unduly convoluted and has become time consuming for the elected incumbents and TCG's Membership and Corporate Governance departments.

The election processes are set out in TCG's Rules and secondary regulations. Each level of the governance structure involves a different process and timetable, and some levels of the three-tier Regional structure employ a variety of different election and voting methods. Despite the complex and time-consuming procedures, the competitiveness of elections, diversity and the churn of elected representatives on certain levels of the governance structure – whilst showing signs of gradual improvement – have been negligible.

The rest of this note sets out the structures and electoral processes in more detail, in the following order:

- Group Board
- Regional Boards
- Area Committees
- Independent Professional Non-Executive Directors on the Group Board
- Group Board Committees
- Values and Principles Board
- Regional Values and Principles Committees
- Subsidiary Boards

2. **Group Board – elected directors**

The 20 elected directors on the Group Board represent two separate member constituencies, the Regions and the Independent Society Members. The term of office for all elected directors is three years.[1] Each year, a third of the directors retire by rotation.

(a) **Regional Elections**

*Procedure*

Candidates for the Regional seats on the Group Board are nominated by Area Committees, and they are then elected in Regional elections by Area Committee members individually from within their Region. The number of Regional

[1] Unless they are filling a 'casual vacancy'.

Directors that Area Committee members can elect from each Region is set out in the Rules, as follows:

| Region | No. of directors |
|---|---|
| Scotland & Northern Ireland | 2 |
| North | 3 |
| North West & North Midlands | 3 |
| Central & Eastern | 2 |
| Cymru/Wales | 1 |
| South & West | 2 |
| South East | 2 |

The allocation of Regional seats on the Group Board was proportionate to sales per Region in the customer-facing businesses (excluding financial services) at the time of the Constitutional Review which followed the merger between TCG and United Co-operatives in 2007.

An overview of the Group Board election process is as follows:

– Nominations will be invited at Area Committee meetings, following which nomination forms must be returned to the Group Secretary, having been signed by the candidate, two Area Committee members from that Area and the Regional Secretary. An Area Committee may only nominate eligible Regional Board members from within its own Area.

– In addition to eligibility requirements (see below), candidates must go through an internal and external[2] screening process (including providing proof of name and address, right to work in the UK, fraud checks etc.). The results of the internal pre-screening checks will be considered by the Group Remuneration and Appointments Committee, which has the ability to determine that a candidate must withdraw their application (in appropriate cases).

– At the point of nomination, candidates are also asked to confirm that: (i) they believe that they are able to fulfil the requirements of the Group Board Role Description and Person Specification, (ii) they will abide by the Group Board Code of Conduct, and (iii) they are committed to maintaining the co-operative status of TCG and to upholding co-operative values and principles.

– Nominated candidates will be asked to provide a recent photograph, biographical details and a short written election address. For a candidate seeking re-election, the Group Secretary will supplement the candidate's address with reference to their Group Board attendance levels, training and appointments. Hustings sessions will be organised by the Regional

[2] The external screening process will be carried out by the Solicitors Regulation Authority for regulatory reasons, with effect from the 2014 Group Board Elections.

Secretary in each Region, where each candidate will give a short address and engage with Area Committee members.

– Ballot papers will be issued by email to each Area Committee member. If no email address is held for an Area Committee member, there is direct liaison between those concerned and Electoral Reform Services.

– Voting entitlement is based on Purchases. Each Area Committee is allocated the relevant number of votes based on trade attributable to the Area, though the number of votes per Area is divided equally by the number of members of that committee, further to which each Area Committee member is allocated an individual weighted vote. Whilst Area Committees may make recommendations, Area Committee members may not be mandated on how to vote.

– The ballot will be conducted using the Single Transferable Vote method. Votes will be examined and counted by Electoral Reform Services (or an alternative independent body).[3] The requisite number of candidates who achieve the required quota first shall be elected to fill the seats up for election, subject to the restrictions below.

*Eligibility*

A person is eligible to stand and be elected (or re-elected) to the Regional seats on the Group Board if:

– at the point of election they will have served less than three consecutive terms of office on the Group Board (whether or not any of those terms are for less than three years);

– at the point of nomination they have completed the Group Board Development Centre ("GBDC") certification process. This requires submission of a 'portfolio of evidence' in respect of seven required competencies, followed by a 'professional discussion' with an independent assessor; and

– at the point of nomination they are and have been a member of a Regional Board for at least the last 24 months.

*Restrictions*

The number of Regional representatives on the Group Board who are "Employees" (as defined in the Rules) should never exceed four. In the event that the number of candidates elected as Regional Directors who are Employees exceeds four, the candidates polling the greatest proportion of votes cast shall fill the vacancies up to the limit. Any remaining vacancies shall be filled by other candidates.

The number of Group Board members who are "Close Relatives" (as defined in the Rules) should never exceed two.

No person shall be nominated in a Corporate Election and a Regional Election for the Group Board at the same time.

[3] While the Group Secretary is the official Returning Officer, in practice, this duty is delegated to ERS and the Group Secretary will not see the votes.

In accordance with Rule 6.24 and the Group Board Canvassing Regulations, a candidate shall not solicit votes, whether in person, by post, email or other electronic means, except in accordance with the Election Regulations. This prohibition applies not just to the candidate, but to their nominating Area Committee, Regional Board and/or any other person on the candidate's behalf.

(b) **Corporate Elections**

*Procedure*

Independent Society Members elect their five Group Board representatives directly via Corporate elections. Corporate elections run in parallel with Regional elections. An overview of the process is as follows:

– Candidates must be nominated by the Independent Society with which they are affiliated. Nomination forms must be returned to the Group Secretary after having been signed by the candidate, two members from that Independent Society and the secretary of the Independent Society (in the event that the candidate is the secretary of the Independent Society, the nomination form should be signed by an alternative officer of the Independent Society).

– In addition to eligibility requirements (see below), candidates must successfully complete the internal and external[4] screening processes (including providing proof of name and address, right to work in the UK, fraud checks etc.). The results of the internal pre-screening check will be considered by the Group Remuneration and Appointments Committee, which has the ability to determine that a candidate must withdraw their application (in appropriate cases).

– At the point of nomination, candidates are also asked to confirm that: (i) they believe that they are able to fulfil the requirements of the Group Board Role Description and Person Specification, (ii) they will abide by the Group Board Code of Conduct, and (iii) they are committed to maintaining the co-operative status of TCG and to upholding co-operative values and principles.

– Nominated candidates will be asked to provide a recent photograph, biographical details and a short written election address. For a candidate seeking re-election, the Group Secretary will supplement the candidate's address with reference to their Group Board attendance levels, training and appointments. There are no hustings sessions for Corporate candidates.

– Ballot papers will be issued by email to the Independent Societies that have registered their wish to vote with TCG Corporate Governance department.

– Voting entitlement is based on Purchases. Each Independent Society Member is allocated one vote plus the relevant number of votes based on their Purchases in the previous financial year, further to which these are cast as a block by the Independent Society Member.

[4] The external screening process will be carried out by the Solicitors Regulation Authority for regulatory reasons, with effect from the 2014 Group Board Elections. For further information, please see the Group Board Election Regulations.

– The ballot will be conducted using the Single Transferable Vote method. Votes will be examined and counted by Electoral Reform Services (or an alternative independent body).[5] The requisite number of candidates who achieve the required quota first shall be elected to fill the seats up for election, subject to the restrictions below.

*Eligibility*

A person is eligible to stand and be elected (or re-elected) to a Corporate seat on the Group Board if:

– at the point of election they will have served less than three consecutive terms of office on the Group Board (whether or not any of those terms are for less than three years);

– at the point of nomination they have completed the GBDC certification process;

– at the point of nomination and election they are any of the Chief Executive, Secretary, Director, or a Senior Manager,[6] of the nominating Independent Society Member; and

– they would not be ineligible to serve as a member of an Area Committee or Regional Board by virtue of the conflicts of interest policy.

*Restrictions*

The number of Group Board members who are 'Close Relatives' should never exceed two.

No person shall be nominated in a Corporate Election and a Regional Election for the Group Board at the same time.

In accordance with Rule 6.24 and the Group Board Canvassing Regulations, a candidate shall not solicit votes, whether in person, by post, email or other electronic means, except in accordance with the Election Regulations. This prohibition applies not just to the candidate, but to their nominating Independent Society Member and/or any other person on the candidate's behalf. This provision is inconsistent with paragraph 9 of the Group Board Canvassing Regulations, which states that "In the Corporate Elections, no Independent Society Member may publically endorse any candidate other than their own, whether in the election of Regional or Independent Society Member representatives."

## 3. Regional Boards

Each of the seven Regions has a Regional Board, which comprises 12 to 15 Regional Board members. Regional Board members are elected by the Area Committee members within the Region to serve a three-year term of office.[7] A third of the Regional Board shall be subject to retirement each year. The electoral year usually runs from 1 January to 31 December.

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[5] While the Group Secretary is the official Returning Officer, in practice, this duty is delegated to ERS and the Group Secretary will not see the votes.
[6] The definition of 'Senior Manager' is set out in the Rules.
[7] Unless they are filling a casual vacancy.

*Election methods*

Different electoral processes apply in different Regions, but broadly speaking, Regional Board Members are elected by Area Committee members in one of two ways:

1. Area Seat method – all seats on the Regional Board are divided among the Area Committees within the Region (with all Area Committees having at least one seat), and filled by the members of the relevant Area Committee electing their representatives to fill their seats; or

2. General and Area Seat method – a proportion of seats are filled by a ballot of all Area Committee members within the Region (General Seats), subject to the condition that at least one seat on the Regional Board must be allocated to each Area within the Region (Area Seats).

The only Regions that have opted to use the General and Area Seat method are the North, Scotland & Northern Ireland and Cymru/Wales.[8]

The Review team has been informed that in elections where the Area Seat method is employed reluctance to stand against sitting candidates appears to be most prevalent. Candidates are more likely to stand in elections utilising General Seats.

*Procedure*

For the Area Seats in both methods, an overview of the election procedure is as follows:

- An Area Committee meeting is scheduled to elect the Area Seat representatives on the Regional Board. In advance of the meeting, eligible candidates must complete and submit a nomination form, which will include a short election statement. The nomination forms are provided to existing Area Committee members in advance of the meeting.

- At the meeting, each eligible candidate must be 'proposed' by a current member of the Area Committee. In the event of only one nomination being received, the candidate's appointment must be ratified by the Area Committee. Before the ballot is conducted at the meeting, each candidate will be given a maximum of five minutes to make an oral address. The Area Committee shall then select its representatives to the Regional Board by secret ballot.

- Each Area Committee member shall have one vote. The Group Board has prescribed the voting method for Area Seat ballots in Regional Regulation 25:

    - Where there is only one vacancy, the method of election will be 'first past the post' in the interests of simplicity. In such instances, the successful candidate must obtain at least 50 percent of the votes available. Where this is not achieved at the first stage, subsequent stages of the ballot will take place, with the candidate in last place being removed from the next round.

    - Where there is more than one vacancy, the method will be a 'reverse points preferential ballot', where points are allocated to each candidate conversely to the voter's order of preference (e.g. in the event of there being five candidates, the voter's first choice is allocated five points, their

8 Cymru/Wales is one of the smallest Regions and has only one General Seat.

second choice four points, and so on, depending on how many preferences are expressed).

– In the event of a tie, in each case, a second secret ballot will be held, involving those candidates who are tied. In the event of this also resulting in a tie, the matter shall be resolved by the drawing of lots.

– Proxy voting or electronic voting is not permitted; only Area Committee members present at the meeting may cast their vote.

For the General Seats of the General and Area Seat method, an overview of the election procedure is as follows:

– All eligible Area Committee members from the Region may stand for General Seat elections. Such candidates must be 'proposed' by a current member of their Area Committee and complete and submit a nomination form.

– Details of the candidates will be posted with a ballot paper to all Area Committee members within the Region at least seven days in advance of the closing date for the election. Unlike the Area Seat election process, no meetings are held and the candidates do not have a chance to orally address the electorate.

– The ballot will be conducted by post and will be organised by a third party. The Regional Board shall have discretion to allocate votes between Area Committee members in the Region based on either one member, one vote (i.e. votes of equal value) or weighted votes based on purchases within each Area and the number of elected members serving on the Area Committee in each Area.

*Eligibility*

An Area Committee member that has been on the Area Committee for at least the last 24 months may be nominated and elected to their Region's Regional Board if (i) they meet the eligibility requirements for an Area Committee (see below), and (ii) they have completed the Co-operative Certificate in Co-operation (for election) or the Co-operative Diploma in Co-operation or GBDC (for re-election).

*Restrictions*

There is no limit on the number of times that a Regional Board member can stand for re-election.

As with the Group Board, there are also a number of provisions which affect the composition of the Regional Board. The number of Regional Board members who are Employees shall be no more than a third of the total, and there cannot be more than two Close Relatives on a Regional Board at any one time. In addition, those persons who are employees or Close Relatives of Employees, taken together, must be less than 50 percent of the Regional Board.

*Co-options*

In addition to the Regional Board election process outlined above, the Group Board may co-opt Individual Members aged 16 years or above to membership of any Regional Board for the limited purposes of:

- filling any vacancies that remain unfilled following elections, and in so doing the Group Board shall have regard to the prevailing diversity (as determined by the Group Board at the time) of the Regional Board concerned;
- increasing the diversity (as determined by the Group Board at the time) of the membership of the Regional Board, so long as only one individual is co-opted on this basis at any time (in addition to any individuals co-opted under the preceding sub-paragraph); or
- recognising and facilitating the movement of Individual Members between Areas (in addition to any individuals co-opted under the two preceding sub-paragraphs).

In any of the above scenarios, the Group Board may, at its discretion, waive any of the eligibility and qualification criteria set out in the Rules.

4. **Area Committees**

Each Area within each of the seven Regions has an Area Committee, which shall consist of 10 to 12 Area Committee members. Northern Ireland has a Members Council instead of an Area Committee, which may comprise up to 20 members. The Northern Ireland Members Council is treated as an Area Committee for the purposes of the Rules and Election Regulations, except where specified differently. Individual Members are nominated and elected on to Area Committees by Individual Members in the Area for a three-year term of office. A third of the Area Committee shall be subject to retirement each year. The electoral year usually runs from 1 September to 31 August.

*Procedure*

Different electoral processes can apply in different Regions. At the recommendation of the Regional Board, the Group Board may divide Areas into Districts for electoral purposes. In the event of District representation, a candidate must be resident within the boundaries of the district. Under Rule 5.17, Regional Boards may reserve seats for ethnic minority members on Area Committees within their Region.[9] An overview of the general election procedure, where Areas have not been divided into Districts and ethnic minority seats are not reserved, is as follows:

- All eligible Individual Members who are resident within the boundaries of the Area may stand for their Area Committee election. Individual Members must complete a nomination form, which shall include biographical details, an election statement and a recent photograph. The election statements should not include any personal contact details or any form of invitation for members to make contact with the candidate. A candidate must have their nomination 'proposed' and 'seconded' by persons aged 16 years or over who are registered within the boundaries of the Area in which the candidate is seeking election.
- Candidates' biographical statements shall be published and distributed to Individual Members with a ballot paper, and will be included on TCG's website. All Individual Members over the age of 16 are entitled to request a ballot paper and vote (voting shall be by postal and internet ballot). Individual Members who meet the criteria determined by the Group Board will be issued with a ballot paper automatically. At present, the criteria determined by the Group Board are:

[9] The South East Region is the only Region to have introduced reserved seats for ethic minority members (for North London and South London Area Committees only). The North Region has agreed to reserve seats for the West Yorkshire Area Committee.

(i) a minimum level of trade with TCG in the past year,[10] and (ii) having voted at least once in the last three years (if the election was contested in every year and if they have been a member for the past three years). In such circumstances, this information will be sent by post or electronically at least 21 days before the closing date for return.

– The voting method used shall be determined by the Group Board. Individual Members shall have one vote. The successful candidates shall be those who poll the greatest number of votes so that all vacancies on the Area Committee are filled.

In the 2013 Area Committee elections, 237,578 members voted (compared to 222,221 in 2012). Overall, 76.2 percent of votes cast were cast by post in 2013 (versus 81.7 percent in 2012) and 23.8 percent of votes were cast online (versus 18.3 percent in 2012). The Values and Principles Board has recently supported a proposal to move to online only elections, with an automated telephone voting service to be provided to those without access to the internet.

*Eligibility*

An Individual Member is eligible to be nominated and elected to an Area Committee if:

– they are over 16 years old;

– their address is within the Area in question;

– they have been an Individual Member for the preceding 12 months and hold not less than £1 in individual shares in TCG;

– they have satisfied trading requirements (i.e. they have made qualifying purchases using their membership card);

– they have committed to the Society's status as a co-operative and its Values and Principles;

– if they are an Employee, they are not a member of the Executive or senior management;

– they have not been previously removed from an Area Committee or Regional Board; and

– they have complied with certain legal status requirements (e.g. disclosure of any criminal record, not bankrupt etc.).

*Restrictions*

– There is no limit on the number of times that an Area Committee member can stand for re-election.

– As for the Group Board and Regional Boards, there are also a number of provisions which affect the composition of an Area Committee. The number of Area Committee members who are "Employees" shall not be more than a third of the total, and there cannot be more than two "Close Relatives" on an Area Committee at any one time. In addition, those persons who are Employees or

[10] 250 Membership Points.

Close Relatives of Employees, taken together, must be less than 50 percent of the Area Committee.

– At the discretion of the Regional Board, seats on the Area Committees within the Region may be reserved for ethnic minority members. If this policy is implemented, then a separate election process applies for ethnic minority reserved seats.

5. **Independent Professional Non-Executive Directors on the Group Board**

In addition to the 20 elected directors on the Group Board, the Board may appoint up to three Independent Professional Non-Executive Directors ("IPNEDs"). While the Rules envisage IPNEDs being appointed to fill gaps identified by an annual skills gap analysis, in practice no such skills gap analysis has been completed.

An IPNED appointed by the Board shall take office upon appointment, but their appointment shall be put to the next Society General Meeting for ratification. If the IPNED's appointment is not ratified, they shall immediately cease to be a member of the Board.

An IPNED is appointed (subject to ratification under the Rules) for up to three years. A person who has served as an IPNED may be re-appointed, but no person may serve more than three consecutive terms as an IPNED.

6. **Group Board Committees**

There are currently three formal Committees of the Group Board: the Group Audit and Risk Committee; the Group Remuneration and Appointments Committee; and the Group Chair's Committee.

In practice, subject to the composition requirements set out in the Rules and the terms of reference of each Committee, Committee appointments are recommended by the Remuneration and Appointments Committee and are made by the Group Board as part of an annual Committee and Subsidiary Board appointment process conducted by the Group Secretary and TCG Corporate Governance department (the "Committee/Subsidiary Board Appointment Process"). An overview of the role and composition of each Committee and the Committee/Subsidiary Board Appointment Process is set out below.

6.1 **Role and composition of Group Board Committees**

(a) **Group Audit and Risk Committee**

*Responsibilities*

Among other things, the Group Audit and Risk Committee oversees the preparation of TCG's accounts, monitors TCG's financial performance and control systems and co-ordinates the work of the corresponding audit committees appointed by TCG's subsidiaries.

*Composition*

The composition is set out in terms of reference dated 12 September 2012. The Group Audit and Risk Committee appointments are subject to recommendation by the Group Remuneration and Appointments Committee, but must consist of:

– not less than five directors appointed by and from the Group Board;

– at least one director from the Food Subsidiary Board; and

– at least one director from the Specialist Businesses Subsidiary Board.

In addition, IPNEDs serving on the Food Subsidiary Board or the Specialist Businesses Subsidiary Board may be appointed to the Committee. The Group Chair may not be a member of the Group Audit and Risk Committee. The Chair of the Group Audit and Risk Committee (who shall always be a Group Board director) shall be appointed by and from the members of the Committee, which appointment is subject to the approval of the Group Board. At least one member of the Committee should have recent and relevant financial experience.

(b) **Group Remuneration and Appointments Committee**

*Responsibilities*

Among other things, the Group Remuneration and Appointments Committee makes recommendations about the remuneration of the Society's senior employees and succession planning, reviews the remuneration and expenses policy of elected members and co-ordinates the remuneration and appointments policy across TCG and its subsidiaries.

*Composition*

The composition is set out in terms of reference dated 10 December 2013. The Committee shall consist of not less than five members, who shall include:

– the Group Chair;

– the Deputy Group Chair(s) (in the absence of whom, up to two other directors appointed by and from the Group Board); and

– two other Directors appointed by and from the Group Board.

In addition, IPNEDs serving on the Food Subsidiary Board or the Specialist Businesses Subsidiary Board may be appointed to the Committee by the Group Board.

The Chair of the Group Remunerations and Appointments Committee (who shall always be a Group Board Director (but not the Group Chair)) shall be appointed by and from the members of the Committee, which appointment is subject to the approval of the Group Board.

(c) **Group Chair's Committee**

*Responsibilities*

The Group Chair's Committee has the authority to act on behalf of the Group Board between Board meetings (if so required in the judgement of the Group Secretary (or in their absence, the Group Chair)). Consequentially, the remit of the Group Chair's Committee covers all areas reserved for the Group Board.

There is considerable ambiguity in the Rules regarding the functions that can be delegated by the Group Board. While in practice the Group Chair's Committee is permitted to act on all areas reserved for the Group Board, it is not clear whether they are constitutionally permitted to do so in respect of certain matters.

*Composition*

The Group Chair's Committee shall comprise:[11]

– the Group Chair;

– the Deputy Group Chair(s);

– the Chair of the Group Values and Principles Board; and

– the Chair of the Group Remuneration and Appointments Committee.

### 6.2 Committee/Subsidiary Board Appointment Process

– In March each year, the Group Secretary and TCG Corporate Governance department ask Group Board members to fill in a nomination form if they wish to be considered for appointment/re-appointment to a particular Subsidiary Board/Committee.

– The term of office on a Subsidiary Board/Committee is three years, and in practice there is no limit on the number of times that Group Board members can be re-appointed to the Subsidiary Board/Committee.

– Once nomination forms have been submitted, a schedule of interests will be submitted to the Group Remuneration and Appointments Committee. To assess the suitability of the Group Board candidates for each Subsidiary Board/Committee, the Group Remuneration and Appointments Committee uses the information provided by Group Board members in their election address. In the event of more nominations than seats for a Subsidiary Board/Committee, Group Board members may also be asked for a written supporting statement. The Group Remuneration and Appointments Committee then makes recommendations to the Group Board.

– The Group Board determines its appointments at its meeting in June to coincide with the retirement/appointment of Group Board members at the May AGM.[12]

– A similar process is conducted for casual vacancies on Committees/Subsidiary Boards, but the Group Board may bypass the Group Remuneration and Appointments Committee if there is limited time.

## 7. Values and Principles Board

The Group Values and Principles Board (the "V&P Board") replaced the Group Values and Principles Committee, the Governance Committee, the Diversity Strategy Committee and the Political Strategy Committee in October 2013. The V&P Board is neither a formal Committee of the Group Board nor the board of a legally constituted entity. It is given the title 'Board' to reflect the fact that it has the same status as the Subsidiary Boards in TCG's governance structure.

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11 N.B. The Rules state that the Group Chair's Committee may also consist of other Directors as the Group Board decides from time to time, but no provision is made for this in the Terms of Reference.

12 Voting for the Subsidiary Boards was carried out by email ballot in 2013.

*Responsibilities*

The V&P Board is the custodian of TCG's co-operative values and principles. It considers and makes recommendations to the Group Board, Subsidiary Boards and Group Board Committees on a number of matters, including Group Board governance issues, Regional governance issues, member engagement, social goal strategies, Group distribution strategy, TCG's relationship with political parties and diversity issues.

*Composition and appointment process*

The V&P Board shall consist of eight Directors appointed by and from the Group Board – one from each Region and one from the Corporate constituency. Ordinarily, appointments shall be for a term of three years and may be renewed, subject to the approval of the Group Board.

The Chair of the V&P Board shall be appointed by and from the members of the V&P Board and shall be subject to approval by the Group Board. The term of office of the V&P Board Chair shall be for a period of three years. The V&P Board shall also appoint a Deputy Chair from the members of the V&P Board. The term of office of the Deputy Chair shall be for three years.

The Group Board appointed the members of the Group Values and Principles Committee, the Governance Committee, the Diversity Strategy Committee and the Political Strategy Committee as part of the Committee/Subsidiary Board Appointment Process outlined in paragraph 6.2 above. It is the intention to adopt this process for the 2014 V&P Board appointments.

## 8. Regional Values and Principles Committees

The Regional Boards delegate day-to-day oversight of the Regional co-operative values and principles agenda to Regional Values and Principles Committees. Terms of reference for the Regional Values and Principles Committees are set out in Appendix 11 of the Regional Regulations.

Regional Values and Principles Committees should comprise:

(a) three representatives of the Regional Board, one of whom shall be the Regional Board Chair or Vice-Chair ("Regional Representatives"); and

(b) two representatives from each Area Committee within the Region, except in those Regions which have the highest number of Areas,[13] in which case each Area Committee will have one seat on the Regional Values & Principles Committee, and further to which at least two 'general seats' will be available within the Region, to ensure that elected members in all Areas have the opportunity to seek election to the Regional Values & Principles Committee in each year of the two-year cycle ("Area Representatives").

*Election of Area Representatives*

Area Representatives are elected by their Area Committee as follows:

– Eligible candidates will be required to complete and submit a nomination form in advance of the Area Committee meeting at which the election will be held (normally at the first Area Committee meeting following the annual Area

13 Only North and Scotland & Northern Ireland in practice, although the wording is deliberately vague.

Committee elections). Candidates must be nominated by a member of their Area Committee. Candidates' details will be circulated in advance of the meeting.

- In the event of only one nomination being received in respect of a vacancy, the candidate's appointment must be ratified by their Area Committee. In the event of there being no such ratification, a fresh election will be called or the seat may be left vacant until the next election, at the discretion of the Area Committee. In the event of there being more nominations than places available, a secret ballot will be held.

- Area Representatives will serve a two-year term of office (subject to them retaining their place on the Area Committee).

- In Regions where Area Committees have two representatives on the Regional Values & Principles Committee, one seat will fall vacant in one year and the other seat in the next year. In Regions where Area Committees each have only one representative on the Regional Values & Principles Committee, an electoral cycle will operate in the interests of continuity, whereby half the seats fall vacant in one year and the other half in the next year. In those Regions, at least one 'general seat' will also fall vacant each year.

*Election of Regional Representatives*

Other than the Regional Board Chair or Vice Chair (who shall be a Regional Representative by virtue of their office), Regional Representatives are elected by Regional Boards as follows:

- Eligible candidates will be required to complete and submit a nomination form in advance of the Regional Board meeting at which the election will be held (normally at the first Regional Board meeting following the annual Regional Board elections). Candidates must be nominated by a member of their Regional Board. Candidates' details will be circulated in advance of the meeting.

- In the event of there being more nominations than places available, a secret ballot will be held.

- The successful candidates will each serve a two-year term (subject to them retaining their seat on the Regional Board). Two of the three seats will be subject to election in one year and the third seat in the following year.

*Eligibility*

Area Committee members seeking election to the Regional Values & Principles Committee are required to have served at least one electoral year of office on the Area Committee (directly preceding their nomination), in order to be eligible.

Candidates seeking election or re-election will be required to have completed the 'Applying our Values & Principles' and 'Developing an Engaged Membership' units of the Certificate in Co-operation programme by the closing date for nominations.

Although not a restriction or eligibility requirement, Area Committees are actively discouraged from appointing Regional Board members as their representatives on the Regional Values & Principles Committee, given that the Regional Board can itself appoint three representatives.

## 9. Subsidiary Boards

TCG owns, controls and co-ordinates its businesses through the following legally constituted subsidiaries: Co-operative Banking Group Limited ("CBG"), Co-operative Specialist Businesses Limited ("Specialist Businesses") and Co-operative Food Holdings Limited (Food, and together with CBG and Specialist Businesses, the "Principal Subsidiary Corporations").

Each Principal Subsidiary Corporation has a Subsidiary Board, which is responsible for the businesses which that Principal Subsidiary Corporation owns and controls.

The composition and appointment process for the Subsidiary Boards is set out in (i) TCG's Rules and (ii) the Rules of each Principal Subsidiary Corporation. In practice, Food and Specialist Businesses Subsidiary Board appointments are recommended by the Group Remuneration and Appointments Committee and appointed by the Group Board as part of the annual Committee/Subsidiary Board Appointment Process described in paragraph 6.2 above. The CBG Subsidiary Board appointment process is carried out separately.

*Position under TCG's Rules*

In accordance with the provisions of TCG Rule 2, the Group Board appoints the members of the Subsidiary Boards, who shall include:

– Directors of the Group Board;

– members of the Executive and/or the Group Chief Executive and/or one or more Executives of the Group appointed by the Board; and

– a number of IPNEDs, not being less than two, or any higher minimum number required by any statutory body with regulatory responsibility over any part of the business of the Principal Subsidiary Corporation.

*Composition and appointment process – Subsidiary Board Rules and practice*

### (a) Food Subsidiary Board

The composition and appointment procedure for the Food Subsidiary Board is set out in the Rules of Co-operative Food Holdings Limited. The board shall be appointed by the Group Board, who shall appoint the directors from time to time from among their own number and from senior management of TCG. In addition, the Group Board may appoint up to two IPNEDs.

In practice, Group Board appointments are made as part of the annual Committee/Subsidiary Board Appointment Process and IPNEDs will be recommended by the Group Remuneration and Appointments Committee from time to time.

The Chair of the Food Subsidiary Board shall be appointed by the Group Board from among the directors of the Food Subsidiary Board.

### (b) Specialist Businesses Subsidiary Board

The composition and appointment procedure for the Specialist Businesses Subsidiary Board is set out in the Rules of Co-operative Specialist Businesses Limited. The board shall be appointed by the Group Board, who shall appoint the directors from time to time from among their own number and from senior management of TCG. In addition, the Group Board may appoint up to two IPNEDs.

In practice, Group Board appointments are made as part of the annual Committee/Subsidiary Board Appointment Process, and IPNEDs will be recommended by the Group Remuneration and Appointments Committee from time to time.

The Chair of the Specialist Businesses Subsidiary Board shall be appointed by the Group Board from among the directors of the Specialist Businesses Subsidiary Board.

(c) **CBG Subsidiary Board**

The board composition and appointment provisions in CBG's Rules were removed as part of the Co-operative Bank plc's recapitalisation planning in October 2013. CBG's Rules state that the CBG board shall not consist of less than four directors, but do not specify who has the power to appoint directors.

The Review team has been told that the Group Board still appoints CBG board members in practice (they approved the current composition of the CBG board in October 2013). As mentioned above, the appointment process is separate from the annual Committee/Subsidiary Board Appointment Process but is still organised by the Group Secretary and TCG Corporate Governance department.

The CBG Subsidiary Board currently comprises members of the Executive and representatives from Group Board and CBG subsidiary entities. Board members are appointed for three-year terms and there is no limit on the number of times that a director can be re-appointed.

Although two of its directly-owned subsidiaries are regulated, CBG itself is not regulated, and there is therefore no requirement for CBG Subsidiary Board members to be "approved persons" under the Financial Services and Markets Act 2000.

The Review team understands that the composition of the CBG Subsidiary Board is not consistent with the Subsidiary Board composition provisions set out in TCG Rule 2.17 (particularly in relation to the required number of IPNEDs).

# Appendix 8

# Consultation questions and summary of consultation responses

## Summary of submissions to Myners Review website

| Category | Number of Submissions[1] |
|---|---|
| 1. Group Board members | 8 |
| 2. Regional Boards | 6 |
| 3. Regional Board members | 20 |
| 4. Area Committees | 26 |
| 5. Area Committee members | 116 |
| 6. Independent Societies | 8 |
| 7. Individual Members | 26 |
| 8. Employees | 13 |
| 9. IPNEDs[2] | 2 |

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| **1. Group Board members** | Included in the main body of Report. Not included in this summary |
| **2. Regional Boards** | |
| **More training needed for Group Board members** | – Several respondents recognised that current Group Board Director skill sets are lacking<br>– Many respondents shared the view that Group Board Directors should receive more training at a higher level than is currently the case |
| **Employees should be more involved** | – Support for greater employee involvement in governance |
| **Board member time commitment is too high** | – Respondents recognised that the high time commitment required of Group Board members reduces diversity and suggested ways that their obligation be reduced, e.g. Group Board should not be obliged to attend Area Committee meetings |
| **Support for devolution** | – A few respondents called for "as much as possible to be devolved… this would reduce the power of a dominant CEO" |

[1] Based on number of submissions as at 23 April 2014. Where an individual or group has made more than one submission, it is counted as a single submission.

[2] Not included in this summary due to low sample size.

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| **3. Regional Board members** | | |
| **Board unable to control management** | – | Many respondents recognised that the Group Board has not been able to control management for a number of years |
| | – | Many respondents expressed the view that capability gaps in Group Board members could be filled through training and "development support from the Executive" |
| **Support for devolution** | – | Several put forward an argument that more power should be given to the Regions and Areas |
| **Necessity for elected Board members** | – | Strong opinions that the Board must have an elected majority |
| **Independent Societies should not be represented on the Group Board** | – | A lack of enthusiasm for having Corporate Directors on the Group Board. Concerns include the conflicts of interest created by having "competing organisations" on the Board and a worry that "Corporate directors do not properly scrutinise as they are too close to the Executive" |
| **4. Area Committees** | | |
| **Diversity of views on three tier structure** | – | Some Area Committees support the current three tier structure because it builds democrats' skills and abilities, provides local knowledge of people standing for election and "filters out mavericks and people who may have take-over intentions" |
| | – | Other respondents recognised that the three tier structure slows down decision-making and means that sometimes there is little competition for seats "which leave electors with little or no choice". It creates a bias towards those people who are time rich, which reduces diversity. "The lack of qualified candidates for Group Board or even Regional Board elections is a challenge" |
| **Calls for greater skill level of Group Board** | – | Most Area Committees recognized that the Group Board needs a significantly higher level of skill than is currently the case, although a few expressed the view that setting skill eligibility criteria is contrary to co-operative principles |
| | – | The majority think the necessary skills can be achieved through better training and development and several suggested the appointment of IPNEDs and/or use of independent business advisers to the Group Board |
| **Area Committee view of their role** | – | Almost all Area Committees want increased involvement in decision-making and more extensive consultation |
| | – | They express a view that "governance should start from the bottom up" and are frustrated that their views have not been "heard or actioned" enough by the Regional Boards, the Group Board or the management "to help with critical business decisions" |
| | – | They describe how they bring local knowledge which can positively impact on commercial activities and play a valuable role building links with their communities, raising awareness of co-operation and |

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| | allocating community funds |
| **Independent Societies should have less influence** | – A number of Area Committees call for a reduction in the amount of influence that Independent Societies have on the Group<br>– Some respondents wanted Independent Society representatives removed from the Group Board<br>– Others thought that the Group Chair should always come from the elected membership |
| **Greater involvement of staff in governance** | – Many would like to see staff encouraged to participate in democracy: "we need a structure designed to give employees a real say… we should be inviting them to become our partners in rebuilding the Co-operative" |
| **5. Area Committee members** | |
| **Entrenchment at Area Committee Level** | – Many newly-elected Area Committee members described how at this level "individual agendas compete with the priorities of the business and slow things down, contrary to the necessities of running a successful business"<br>– Other respondents described an "old boys club" at Area Committee level, which is not representative of customers and not open to new ways of doing things "with their main attribute being longevity"<br>– One Area Committee member who has served for two years describes how "our committee structure and make up has very little relevance to the wider membership of 7 million people. Most of the Committee members do not have a link that serves the local community… it is purely focussed on their personal causes |
| **Board capabilities need to improve** | – Many respondents acknowledged that Group Board capabilities need improvement<br>– Most respondents suggested that this can be achieved through putting elected members through more stringent eligibility criteria and rigorous training |
| **Support for employee involvement** | – Support for greater employee involvement in decision-making and governance |
| **Role of Area Committees** | – Individual Area Committee member submissions indicate much more interest in improving local stores to provide for members' needs than in distributing Community Funds<br>– Many see the Area Committees' primary role as providing input and feedback to their local stores |
| **Diversity of views on Area Committee costs** | – Many respondents recognised the costs involved with supporting the Area Committees and questioned the value, arguing that "the money spent on committees and meetings could be better spent on improving the stores"<br>– One member described how "the half yearly meetings for the wider membership serve very little purpose. They are attended by as few as 50 members, most of whom are aged between 65-80 and it is apparent that the buffet provided at the start is the main purpose |

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| | for attending” |
| | – There are others who express the counter view that Area Committees provide great value for money |
| **Calls for funding review** | – Many calls to cancel funding to sister organisations. “We support a lot of alliances but get nothing back in return” |
| **Improving member engagement** | – Lots of suggestions on how to use technology to improve member engagements, e.g. Area Committee meetings via Skype, member voting online, allocation of funds at the till |
| **6. Independent Societies** | |
| **Support for direct election of Group Board members** | – There is near consensus support in the submissions for dismantling the three tier structure and holding direct elections with the rationale that this would encourage more candidates to stand for election, encourage suitably experienced people to come forward and “strengthen accountability to members” |
| | – The Area Committee and Regional Board structures are described as “cumbersome, expensive to operate and probably difficult for lay members (not activists) to understand and engage with” |
| | – “From a commercial point of view the structure risks acting as a brake on swift decision-making which could have adverse consequences in such a competitive environment” |
| **7. Individual Members** | |
| **Support for greater member involvement** | – Member submissions are diverse in views but there is strong agreement that members should be able to become more involved |
| | – The current system of democracy is described as a “sham” and there are calls for increased accountability from the Group Board to members |
| **Concerns about remuneration** | – A few concerns about high remuneration for board members and management |
| **Support for greater employee involvement** | – Support for employee involvement in governance |
| **8. Employees** | |
| **Employee involvement in governance needs to increase** | – Of the 13 employees who made submissions, at least four are Membership department employees and/or elected members who are also employees |
| | – One employee submission pointed out that most employees were unaware of their right to submit concerns as the elected members saw the Review as “theirs” |
| | – A view that the current democratic structure needs more employee representation, e.g. through an employee council |

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| **Concern about the cost of Area Committees** | – There is a view among those making submissions that Area Committees are expensive and do not add value to TCG's business. "They could be replaced with social media platforms and unpaid member panels" |
| **Call for more diversity** | – Calls for increased gender parity and ethnic diversity in the democratic structure |

# Appendix 9

# Frequently asked questions (FAQs)

| Question | Answer |
|---|---|
| **Context** | |
| "Is TCG really 'ungovernable?'" | – I understand why Euan Sutherland felt pushed to say this but there are lots of great things about the Co-op and it has remarkable potential to develop a purpose-driven strategy which will create a Co-op that will truly be different and make a difference. But this won't happen if governance is not radically reformed. Any attempt to trim my proposals will increase risk and diminish potential |
| "You've got it all wrong. Recent mistakes are entirely the fault of management. The Board had nothing to do with it." | – That view ignores the very reason that boards exist. Taking responsibility is primarily what a board is there for<br>– The board of an organisation is ultimately responsible for hiring, monitoring, supporting and, where necessary, removing the management team<br>– While a board may not automatically deserve blame for specific management mistakes and misjudgements, recurring strategic errors or monitoring failures of the scale and consistency of those at TCG show that the Group Board has been equally at fault. It has not had the abilities to monitor management or provide them with high quality challenge and support. Nor has it proved willing to remove bad management when others with more experience would have realised that this was the best course of action<br>– But that is not to point the finger solely at current and former board directors. There is a more fundamental failure which is a systemic failure of the Group's governance – in that context, the recent crisis was, to an extent, inevitable |
| "Did you want to become the Chair of TCG?" | – This might have been in the minds of some, but I realised early on that this would only be possible if I was willing to pull my punches on the seriousness of the situation and seriously compromise the clarity of my recommendations. This would have been a disservice to the members |
| "Did you resign from the Board because of opposition to your reforms?" | – Contrary to the portrayal in the media, I did not resign as a result of opposition to my proposals. As I mentioned on several occasions, I view my role as akin to a medical doctor charged with undertaking a rigorous diagnosis and dispensing the needed prescription, whether or not the patient is willing to accept the hard truths and take the required medication. Given that I have called for a complete governance overhaul, I had expected considerable opposition from elected members<br>– I resigned because of the unwillingness and incapability of some Group Board members to take their responsibilities with the requisite diligence and accountability. I could not be part of a board which takes such a cavalier attitude<br>– My resignation, however, has not weakened my commitment to ensuring that the Group achieves the radical reform of its governance so vital to its continued survival |

| Question | Answer |
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| **Commitment to TGC Values & Principles** | |
| "Are you just opposed to Co-ops? In what circumstances do they work best?" | – I have always been a strong supporter of co-operatives and of mutual ownership generally<br>– Co-ops work best when they meet the shared needs of their members. In the past that meant safe food at the cheapest possible price<br>– In today's world, the advantages of co-operation cannot be taken for granted. They have to be earned day-by-day by providing outstanding service and value for money in comparison with other retailers<br>– Co-ops need to find points of difference that really matter to their members. For some this means a commitment to ethical trading. For others it means finding ways to contribute to the local community. For most it means high quality and value for money<br>– The Group has some exciting plans for developing its future activities in this area. I am sure that as these plans get implemented they will be widely supported |
| "Some people have argued that you should not describe TCG as an "organisation" as this diminishes its uniqueness, what do you think?" | – This point has been made to me but it is a nonsense |
| "How will your recommendations ensure commitment to Co-op Values and Principles are ensured in practice?" | I am deeply committed to maintaining TCG Values and Principles which make this organisation unique and this commitment has shaped my recommendations. It is clear that without its Values and Principles, TCG's reputation and point of value for customers and members would be severely eroded. Examples of how this has shaped my recommendations include:<br>– The NMC will play the critical role of guardian of TCG Values and Principles<br>– Demonstrated commitment to TCG Values and Principles will be an integral part of the Group Board candidate selection process<br>– The Group Board will be directed to act in accordance with TCG Values and Principles by virtue of their appointment letters and contracts and a revised code of conduct<br>– All Group Board members must be members of TCG and attend periodic training and briefing on TCG Values and Principles<br>– The annual evaluation of the individual directors and the Board will include Values and Principles criteria<br>– The NMC will be able to express its concerns to the membership if it feels that the whole Group Board (or individual directors) are deemed to be acting in a way that contradicts TCG Values and Principles |
| "Structures like the ones you are proposing did not stop the collapse of private sector companies like RBS or Woolworths. Why will it work for TCG?" | – No governance structure can guarantee success but there is a convincing body of evidence that a structure along the lines I have proposed significantly reduces the risk of extreme failure |

| Question | Answer |
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| "How do these recommendations encourage diversity?" | – Diversity goes to the heart of co-operative values and makes good business sense<br>– The Nominations Committee will follow best practice to encourage diversity<br>– The NMC will have a training budget for the membership and can choose how it uses this. It can allocate a portion to encourage diversity at all levels of TCG governance and/or among members and employees |
| "Is training for members of the NMC and local bodies going to be stopped?" | – Under ICA Principle 5, training for different groups of members is an essential feature of co-operation. This will continue, within a budget agreed by the Board and allocated by the NMC<br>– In future, training should be provided by a much broader range of suppliers, including universities |
| **Composition of Group Board** | |
| "What are the differences in the current governance structure between "lay directors", "corporate directors" and "elected directors" | – In my Report, "lay directors" are the 15 Group Board members elected via competitive Regional elections to represent Individual Members, "Corporate directors" are the five Group Board members elected to represent the Independent Society Members and the term "elected directors" is used to refer to both lay directors and Corporate directors |
| "Why are you proposing that there are no lay directors on the Group Board?" | – The evidence I have gathered, and the recent crisis at the Group, show that having lay directors – without regard to whether they possess the requisite commercial competence – on the Board, while ideologically attractive, is in practice a flawed concept<br>– Being an effective NED on the board of TCG is a highly challenging role that requires – in addition to a demonstrated commitment to values and principles – extremely strong commercial capabilities and experience<br>– In this fast moving business environment the Board needs to be able to respond quickly and decisively. Having people with inadequate commercial capabilities or experience would slow down its work, particularly if they need more time or external advice to be able to contribute substantively. One Group Board director suggested seriously that as an alternative each lay director should have an experienced advisor seated behind them at board meetings who could whisper advice into their ears during board meetings<br>– Importantly all members of the Group Board will be TCG members. But I believe that an IPNED-'lay' director distinction is divisive and it sets up a situation of tokenism whereby lay directors are on the Board because of who they are as opposed to what they can offer in terms of capabilities and experience<br>– The NMC can put candidates forward to the Nominations Committee – as long as they meet the competency bar but these will not be known as "lay directors"<br>– Members in certain number will be able to propose candidates meeting the competency bar for the Group Board |
| "Without 'lay' directors, how will you ensure members' views are taken into account?" | – There are other ways of receiving member input and views without having 'lay' members on the Board e.g. reports from NMC and focussed research |

| Question | Answer |
|---|---|
| "The Co-op Bank had IPNEDs and they didn't stop the problems there. Why should we believe that having all IPNEDs on the Group Board will prevent further problems?" | – The IPNEDS on the CBG board were not in a majority until 2013 and none of them had previous experience of being a director of a significant commercial and retail bank<br>– As the Kelly Review has found, their influence on major issues was constrained and so their ability to shape decisions was limited |
| "Why aren't you proposing a two-tier structure with a supervisory board similar to those in Europe?" | – The model I propose is conceptually similar to the two-tier structure that some (including external commentators) have advocated for TCG. Under both models, responsibility for directing and overseeing the business is separate from guarding the values and steering the social goals agenda<br>– One reason that a two-tier structure has been proposed for TCG is because its advocates believe that members sitting on the upper "supervisory" board are shielded from legal liability. However, in countries with two-tier boards such as Germany and the Netherlands, supervisory directors do face legal liability, albeit to a lesser extent than members of the management board. Several German supervisory boards have, in fact, been sued in recent years for breaches of fiduciary obligations<br>– A two-tier board structure is not formally recognised under English law, with the attendant risk that it may not be possible to apportion legal liability between a supervisory board and an operating board in the same way as, for instance, in Germany. This would then expose members of a TCG supervisory board to unclear and undefined legal risks. Legal certainty cannot be in doubt and obviously I cannot endorse any proposed governance structure in which the underlying legal basis is unclear |
| "How will the nominations process work? Will there be a competitive element?" | – The present system of competitive elections for the Group Board has no mechanism to achieve a balanced board. It is similar to asking 11 football managers to nominate a player for a team without consulting with or knowing the choice of the others. You could end up with a team of 11 left backs<br>– I have recommended a nominations process which will create the best possible balance and standard of skills on the Board<br>– The Nominations Committee will identify the skills needed by the Board (including a proven commitment to V&P for all candidates) and seek to ensure the directors collectively have them<br>– For each vacancy, it will find NED candidates that possess these skills through adverts, search firms and suggestions from the NMC and broader membership and recommend the best one to the Board<br>– If the Board accepts, then the candidate will be appointed and will come up for election by the membership at the next Society General Meeting<br>– The two NMC members of the Nominations Committee will be able to give confidence that the nominations process is transparent and objective<br>– In addition, a specific number of members will be able to nominate an alternative candidate who meet the requisite competency bar to be considered alongside the Board appointee at the next Society General Meeting |
| "Why do all board members need such a high level of commercial expertise and acumen?" | – Each and every member of the Group Board needs to be highly competent in respect of commercial and financial matters to be able to fully understand the issues presented to them. This is critical because the Group competes with some of the largest and best-run companies in the private sector. The Group Board's work is primarily concerned with commercial and financial issues while the NMC will be the guardian of Values and Principles |

| Question | Answer |
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| "Government does not impose a skills requirement on candidates seeking political office, so why should it be necessary for TCG to require candidates to meet a commercial competence threshold?" | – This analogy is inappropriate because, unlike government which can generate revenue through taxation, TCG must earn every penny by attracting customers. Accordingly the Group Board needs to comprise individuals who excel at creating value |
| "Given everything you have said, would any self-respecting business professional want to sit on our Board?" | – If the recommended governance changes are made, I think TCG can have a bright future<br>– Joining the Board at this turning point in the Group's history would be a fantastically exciting opportunity and there are many highly capable individuals with the correct skills and experience who share an affinity with TCG Values and Principles who would be drawn by the opportunity to lead this organisation |
| **National Membership Council** | |
| "Will the NMC have sufficient power to 'control' the Group Board?" | The NMC will have a variety of mechanisms to hold the Group Board to account but will not "control" it as the latter would raise shadow director liability issues. In particular:<br>– The NMC can demand Q&A with the Executive<br>– The Executive will have to explain any non-compliance with NMC advice in the Annual Report<br>– The NMC can publish its views on Board performance and on any directors up for election to the Board<br>– The NMC will have two seats on the Nominations Committee so they can ensure a fair and transparent nomination process. If the NMC Nomination Committee members are unhappy with the process, they can communicate this to the NMC and the members<br>– Members will have ultimate control over the composition of the Group Board via direct elections at the AGM<br>– The NMC will have the power to ensure that any future changes to the revised constitution do not weaken its adherence to co-operative values and principles |
| "Why aren't a majority of the members of the Nominations Committee drawn from the NMC, the representation of the owners?" | – The Nominations Committee is charged with putting together for members approval a board possessing highly specialised skills and this is best done by those with a deep understanding of the requirements<br>– While NMC members on the Nominations Committee are expected to contribute meaningfully, I have included them primarily to enable TCG members to have greater confidence in the nominations process |
| "What are the eligibility requirements for running for a seat on the NMC?" | – I am recommending that the current Area Committee requirements are adopted (e.g. 250 trading points, member for one year) but would welcome input from members |

| Question | Answer |
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| "What will be the role of the NMC in monitoring performance of the stores?" | – Local store monitoring and closure decisions will be the responsibility of management and the NMC's input will be at a national level<br>– If it chooses, the NMC can receive national performance data (subject to commercial and confidentiality issues) and can choose to discuss this at its meetings and with the Executive and/or Board<br>– The proposed digitisation of members will make much easier for individual members to provide local feedback |
| **Area Committees** | |
| "What will be the future role of Area Committees?" | – I understand that the future role and function of Area Committees will be redefined in line with the Group's new Purpose and Strategy and reinforced to focus on building local membership and supporting community initiatives aligned with the development of the Group's priorities in individual localities<br>– I am recommending that Area Committees will no longer have a role in the democratic election process |
| **Members Rights** | |
| "What are the practicalities of allowing all members to attend Society General Meetings?" | This has yet to be finalised but recommendations include:<br>– Introduction of proxy voting by post or electronically<br>– The Group should make every effort to find a suitably large venue to allow all willing members to attend. If the number of members wishing to attend in person exceeds the capacity of available meeting venues, the available seats should be allocated by the drawing of lots<br>– Use of technology to broadcast meetings over the internet with all members able to submit questions in advance<br>– In addition there will be Executive and Board roadshows throughout the year to provide an opportunity for Q&A with the membership<br>– There will NOT be separate but parallel AGMs in different Regions |
| "Why are you trusting ordinary members with decisions about significant transactions when you don't trust current board members?" | – Significant transactions will be infrequent because they will be defined as involving more than 20 or 25 percent of Group assets<br>– If open to the whole membership there will be a public debate and commentary which will inform the decision. At the moment the Group Board could sell practically everything without the consent of the owners |
| "Will I be able to read press reports of the May 2014 AGM and SGM?" | – No. Under current Group practice Society General Meetings are always closed to the press and members except those elected members currently entitled to attend. The AGM and SGM in May will be no exception<br>– A few days after the meeting, a summary of the discussions and answers to detailed technical questions will be put onto the members' website<br>– The AGM will be filmed and extracts will be put on the members' website in early June 2014<br>– I believe that the press should be welcome to report on Society General Meetings (surely this must be right for an organisation that prides itself on democracy and openness?) and I hope that the Group will reverse its policy in time for the press to attend this month's meetings |

| Question | Answer |
|---|---|
| "Do you recommend that the Co-op continues to make political donations?" | – This must be a matter for members and they should be properly consulted. It is not for me to make a recommendation about this |
| **Existing intermediary governance** | |
| "What will happen to the Subsidiary Boards, Regional Boards, V&P Board and Regional V&P Committees?" | – The responsibilities of the Subsidiary Boards will be scaled back<br>– The V&P Board, Regional Boards and Regional V&P Committees will be disbanded and their responsibilities assumed by the NMC |
| "How many people are currently paid fees for performing some role in TCG governance?" | – There are currently over 100 employees in the Group Corporate Governance department and Membership team combined |
| **Corporate members** | |
| "How will Corporate Members be represented in the proposed governance framework?" | – The independent societies will no longer be allocated seats on the Group Board but will be represented on the NMC and its Steering Committee<br>– They will be granted additional voting rights based on 'purchases' but the total votes cast by Independent Society Members in the SGM will be capped at the aggregate proportion of their purchases |
| **Engagement** | |
| "Has 'Has Your Say' influenced your recommendations?" | – I have not seen the outcome of Have Your Say. It had nothing to do with this Review and has not influenced my recommendations in any way |
| "What changes have you made as a result of engagement?" | I have responded to submissions and feedback in many ways, including:<br>– Direct election to the Board<br>– 3 year term for members of the Board<br>– Guaranteed employee role in governance through representation on the NMC and Steering Committee<br>– Ability of a certain number of members to nominate alternative candidates for election to the Board<br>– Annual evaluation of individual directors and the Board to include V&P criteria<br>– NMC authority to allocate of a training and development budget |

| Question | Answer |
|---|---|
| | – Reserved seats on the NMC for "special constituencies" such as the Young Members' Board<br>– Reduction in the size of the NMC from initial proposal of 100 members to 50 members |
| "What's the rush? Why hasn't the Review taken more time to engage more extensively?" | I have given webinars, read submissions and, with my team, engaged with all of the Regional Boards and many third parties. However, the Group is in an extremely challenging situation and in April I realised that the time for consulting must end and urgent action was required. In particular:<br>– The financial situation of the Group is very challenging with extremely high levels of debt. TCG's credit rating has been reduced to "junk" rating which means it needs to pay higher interest rates to compensate for the extra risk that its debt providers take thus exacerbating the indebtedness every day<br>– The Group's creditors are looking for assurance that TCG will have significant governance reform otherwise they could choose to raise the interest rate and/or impose more stringent conditions, including control rights<br>– Of all TCG's businesses only funeralcare generates more than its cost of capital. This means the Group is losing value every day in its day to day operations<br>– The grocery market is fiercely competitive and looks to remain so in the medium term<br>– With the Group's governance in its current state, it will be impossible to recruit a high enough quality CEO with experience of working with an organisation of the Group's scale and complexity. Other co-operatives in the UK are much smaller and simpler than TCG |
| "Why wouldn't you negotiate? Why wouldn't you cut a deal before the Society General Meeting – that is the way we do things in the Co-op?" | – I committed to giving the membership a full diagnosis and the best possible advice, much as a physician would diagnose and treat a patient. I did not want my advice and recommendations to be watered down through negotiation as then they would no longer prescribe the best solution for the organisation |
| **Management** | |
| "Do we now have the right management team?" | – Richard Pennycook and his core leadership team are first class. They are professional and well respected. They also have a high sense of duty and a great respect for co-operative values. It would be sad to lose any of them |
| **Transitional arrangements** | |
| "Will all elected members be removed from office if the proposals are adopted?" | – No. Transitional arrangements will be put in place to ensure continuity, maintain institutional knowledge and minimise disruption<br>– 35-40 current elected members will occupy the seats required for the NMC to be functional at inception<br>– All Area Committee members are expected to remain in their roles in the near to medium term (pending revision to their number and remit) |

| Question | Answer |
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| "What is your greatest fear about what happens next with your governance review?" | – That the resolution put forward to the SGM by the Board (I could not propose a resolution myself) will pass but that the organisation will dither and delay on next steps and, in so doing, increase business and financial risk and lose the momentum that has been established. There are some who would whisper "that is exactly what we intend to do" |

# Appendix 10

# Glossary of terms

| Term | Definition |
|---|---|
| Annual skills audit | An annual board analysis to establish whether a board has the skills and experience to meet an organisation's needs. Under TCG's Rules, a skills audit must be undertaken annually |
| Area | Each Region is divided into two or more Areas, the geographical boundaries of which are determined by the Regional Regulations. There are currently 48 Areas in total, each of which has an Area Committee or Members Council |
| Area Committee | Each Area has an Area Committee, which shall comprise 10 to 12 members. Northern Ireland has a Members Council rather than an Area Committee |
| Blair/Monks Co-operative Commission Report | The 2001 report of the Co-operative Commission chaired by John Monks. The Commission's aim was to review the strategy and structures of the Co-operative Movement and to suggest ways to develop and modernise. The final report entitled "*The co-operative advantage: Creating a successful family of Co-operative businesses*" was published in January 2001 |
| Carpetbagger | In this context , carpetbagging refers to the risk of individuals securing control of the governance of TCG and then demutualising it for their personal enrichment |
| CBG | Co-operative Banking Group Limited (formerly known as Co-operative Financial Services Limited ("CFS")). CBG is one of TCG's subsidiaries, which has a Subsidiary Board. It is also the umbrella holding entity for TCG's financial services-related businesses, including CIS General Insurance Ltd, Co-operative Insurance Society Ltd and TCG's stake in The Co-operative Bank p.l.c. |
| CEO | Chief Executive Officer |
| CFO | Chief Financial Officer |
| Co-operative Movement | The co-operative movement in the United Kingdom |
| Co-operative Retail Trading Group (CRTG) | CRTG is the pooled buying arrangement between TCG and the independent societies. It was set up in 1993 to centralise the buying of food for the food businesses of co-operative societies |
| Committees | There are currently four committees of the Group Board: the Audit and Risk committee, the Group Chair's committee, the Remuneration and Appointments committee and the Values and Principles Board |
| Corporate director | The five directors on the Group Board elected by and from the Independent Society Members |
| Corporate Election | The annual election process whereby the Corporate directors on the Group Board are elected by Independent Society Members |
| Corporate Governance department | The department of TCG that supports the Group Board and legally constituted subsidiaries. The department is separate from the Membership team |
| CRS | Co-operative Retail Services (merged with CWS to form TCG in 2001) |
| CWS | Co-operative Wholesale Society (merged with CRS to form TCG in 2001) |

| Term | Definition |
|---|---|
| Delegation | Individual Members and Independent Society Members are represented at Society General Meetings by Delegations. The number of delegates which any Region or Independent Society Members may appoint is based on purchases and range from two to 18 |
| Demutualisation | A transaction under which an organisation ceases to be a mutual and becomes or is acquired by a company |
| Elected directors | The term used to refer to both lay (also referred to as Regional) directors and Corporate directors on the Group Board |
| Elected members | The term used to refer to Area Committee members, Regional Board members and Group Board members |
| Employee members | Individual Members that are employed by TCG. Employee members are not a separate class of member under TCG's Rules |
| Executive | TCG's executive management team |
| Financial Conduct Authority (FCA) | Formed on 1 April 2013 as a successor, along with the Prudential Regulation Authority, to the Financial Services Authority (FSA)<br><br>In addition to its role as a conduct regulator of the financial services industry in the UK as provided by the Financial Services and Markets Act 2000, the FCA is also the registering authority for co-operative societies pursuant to industrial and provident societies legislation |
| Gaitskell and Crosland Co-operative Independent Commission | The Co-operative Independent Commission which was established under the chairmanship of Hugh Gaitskell. The final report was published in 1958 |
| Governance | The structures, rules and processes by which an organisation is directed and controlled. The governance framework specifies the distribution of rights and responsibilities among the different participants in an organisation – primarily owners, the board of directors and management – and sets the rules and procedures for decision-making. Good governance seeks to enhance alignment of interest, accountability and transparency in order to improve organisational performance |
| Group Board | TCG's board of directors |
| Group Chair | The chair of the Group Board |
| Group Secretary | The secretary to the Group Board. The Group Secretary is also a member of the Executive by virtue of their office |
| ICA | International Co-operative Alliance |
| Independent societies | The term used by the Review to refer to other co-operative societies in the UK |
| Independent Society Member | TCG has Individual Members and Independent Society Members. Independent Society Members are the approximately 130 independent co-operative societies and other corporates recorded in the Society's register of members |
| Individual Member | TCG has Individual Members and Independent Society Members. Individual members are the approximately 8.1 million individual consumer members whose names are recorded in the Society's register of members |
| IPNED | Independent professional non-executive director. Under TCG's Rules the Group may appoint up to three IPNEDs to fill skills gaps on the Group Board |

| Term | Definition |
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| INED | Independent non-executive director |
| Kelly Review | In August 2013, TCG commissioned an independent review, chaired by Sir Christopher Kelly, into the events leading to the near collapse of The Co-operative Bank. The final report entitled "*Failings in management and governance: report of the independent review into the events leading to The Co-operative Bank's capital shortfall*" was published on 30 April 2014 |
| Lay director | The 15 directors on the Group Board elected by and from the Regions. Also referred to as Regional directors |
| Membership department | The department of TCG that supports the Regional Boards, Area Committees and the wider membership, as well as TCG's social goals. The department is separate from the Corporate Governance department |
| National Membership Council (NMC) | The National Membership Council proposed by the Review (see Recommendations 10 to 14 in Chapter 5) |
| One member, one vote (OMOV) | A fundamental co-operative principle that each member has equal voting rights regardless of their investment in a society |
| Purchases | In certain parts of TCG's governance structure, members' participation rights (e.g. voting and Delegation entitlement) are linked to "purchases" (i.e. trade with the Society) in the previous financial year. The definition of purchases is determined by the Group Board and presently includes categories such as food purchased through CRTG, petrol, healthcare and funerals. Purchase-based participation is the legacy of corporate ownership where voting rights in CWS were proportional to corporate purchases by individual retail societies |
| Regions | Individual Members are divided into the following seven geographical Regions: Central & Eastern, Cymru/Wales, North, North West & North Midlands, Scotland & Northern Ireland, South & West and South East |
| Regional Board | Each of the seven Regions has a Regional Board, which shall comprise 12 to 15 members. Although they are known as "boards", the Regional bodies are not affiliated with separately constituted legal entities |
| Regional director | The 15 directors on the Group Board elected by and from the Regions. Also referred to as Regional directors. Also known as a lay director |
| Regional Election | The annual election process whereby the Regional directors on the Group Board are elected by Area Committee members from within their Region |
| Regional Meetings | Meetings for Individual Members registered in each Region. Despite having recognition in the Rules, Regional Meetings are not official meetings of the Society |
| Regional Secretary | Each of the seven Regions has a Regional Secretary. Regional Secretaries are part of the Membership team |
| Regional Values and Principles Committee | Each of the seven Regions has a Regional Values and Principles committee to oversee the Regional values and principles agenda |
| Regulations | The secondary regulations, codes of practice and standing orders of TCG, including (inter alia): the Purchases Regulations; the Group Board Election Regulations; the Group Board Code of Conduct; the Group Board Roles and Responsibilities; the Group Board Role Description and Person Specification; the Group Board Election Canvassing Code of Conduct; Group Board Meeting Standing Orders; the Group Society General Meeting Standing Orders; the Group Board Diversity Policy; the Group Board Learning and Development Policy; and the Regional Regulations (including, |

| Term | Definition |
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| | inter alia, the Elected Members Code of Conduct) |
| Review | The independent Review of TCG's governance led by Lord Myners |
| Rules | The principal constitutional document of TCG that sets out the way in which the Society is owned, organised and governed. The equivalent of a company's articles of association |
| Rules and Practices Review | The internal constitutional review of TCG that followed the merger of CWS and CRS in 2000 |
| Sister organisation | The term used by the Review to refer to organisations which are part of the Co-operative Movement, e.g. Co-operatives UK and The Co-operative Press |
| Society | A co-operative society registered under the Industrial and Provident Societies Act 1965. The "Society" refers to TCG |
| Society General Meetings | The Annual General Meeting, Half Yearly Meeting and Special General Meetings of the Group |
| Subsidiary Board | TCG owns, controls and co-ordinates its businesses through the following legally constituted subsidiaries: Co-operative Banking Group Limited ("CBG"), Co-operative Specialist Businesses Limited ("Specialist Businesses") and Co-operative Food Holdings Limited ("Food"). Each of these entities has a Subsidiary Board, which is appointed by the Group Board |
| TCG, the Group, the Society | The terms used to refer to the Co-operative Group |
| The Co-operative Bank, the Bank | The Co-operative Bank p.l.c. |
| Three-tier structure | The branch of TCG's governance structure that comprises the Group Board, seven Regional Boards and 48 Area Committees |
| Values and Principles | The ethical values and principles that underpin TCG's identity. The phrase can sometimes refer to the ICA's formal statement of values and principles. See Exhibit 2 |
| 2007 – 2009 Constitutional Review | The internal constitutional review of TCG that followed the merger with United Co-operative Society in 2007 |