

21st Century Pioneers

The Co-operative Group Constitutional Review

Part 1

December 2007

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Acknowledgement

This report has been produced by Mutuo for the Co-operative Group's Constitutional Review Board. The report's purpose is to provide an evidence and information base upon which all stakeholders can draw in considering their contribution to the ongoing constitutional review.

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Peter Hunt

Mutuo, *December 2007*

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21st Century Pioneers

The Co-operative Group Constitutional Review

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Part 1
The Key Issues: A Driving Force for Reform

Preface

This review is intended to enable the Co-operative Group to modernise its governance structure, deliver greater stakeholder engagement and enhance the commercial performance of the businesses that operate within it.

As a business with an annual turnover of more than £9bn and 87,500 employees, the Group needs to consider whether its current constitution provides the most efficient means of sustaining future growth and meeting the aspirations of over 4.5 million members.

The review process is taking place in tandem with the changing emphasis of the Co-operative Group, where expansion and new business development has replaced consolidation as a key marker of performance.

The unique nature and ownership structure of the Co-operative Group in the UK retail sector means that it faces strong commercial pressure. The Group operates in highly regulated UK environments that are most competitive. Its major competitive rivals exert pressure on Group business in markets that are prone to the entry of new competitors.

That is why a robust approach to governance reform is vital both for the future development of the Group and the continuance of the beneficial contribution made by the co-operative movement to communities throughout the length and breadth of the United Kingdom.

Through undertaking this review the Co-operative Group can ensure that the legacy of the Rochdale Pioneers will be taken through to the 21st century and that the activist spirit of the movement can be enhanced through a clear delineation of the roles and responsibilities of each stakeholder.

The original Co-operative principles of self-help, self-responsibility, democracy, equality, equity and solidarity are fundamental to today's growing corporate and social responsibility movement, as are the ethical values of honesty, openness, social responsibility and caring for others. This review can ensure that the Co-operative Group provides the leadership that is needed in the pursuance of ethical trading in a highly competitive retail sector.

Executive Summary

What do the Co-operative Group's stakeholders think?

The view from all key stakeholders was that the merger of the two societies to form a new Group offered a historic opportunity to turn around the fortunes of the movement.

It was felt that major constitutional changes were necessary to take advantage of this opportunity. The strong feeling from the research was that this opportunity should not be missed.

It was felt that the Group's development had been unplanned and that this had resulted in a complex organisation that was unable to meet its commercial challenges.

There were real fears that the necessary governance reform would be "fudged", leading to a period of relative decline.

There was almost unanimous belief that the Board was simply too big to perform effectively or for the individual members to contribute effectively.

The current process whereby people become directors through a process of representation by election was felt not to produce the calibre of people needed to run a business of the current size and scale.

There were differences of opinions about the role of members within the Group. The clear implication here is that the governance review should set out the respective roles of the key stakeholders in the Co-operative Group.

What is corporate governance and what is its aim?

Corporate governance comprises what *all* of the organs of the corporate entity do, not just what the board of directors does.

Corporate governance is a means to an end: delivering the vision of the founders of the corporate entity (the corporate purpose), by providing a vehicle to run a business, and limit the liability of the owners.

The overarching aim of corporate governance is to establish arrangements which

- Meet the needs of the business
- Ensure that those responsible for the business are competent to do the job in the particular commercial environment
- Provide a framework of accountability to the owners
- Drive the efficiency and success of the organisation

The prompt availability of appropriate trading information to the appropriate levels for members and members' representatives is needed to assist in driving such efficiency and success.

What does it mean to be a co-operative

Being a cooperative business is not simply a question of what the business does with its profits.

A cooperative is owned and controlled by its members, and exists to provide goods and services on a cooperative basis to members and other customers.

The central message of the Cooperative Commission, and the implementation by the Cooperative Group of a number of its recommendations on brand and membership go a long way towards articulating what it means to trade as a cooperative in the 21st Century.

Being profitable remains the pre-requisite for survival and the principal focus of management. But being a cooperative business, and having that unique selling point in the market-place, brings with it the need for managers to accept that the ownership and governance structure are different from a PLC.

The ownership and governance structure should be designed (re-designed) to add value to the business at every level, and not to impede it.

Co-operative corporate governance

The separation of board and management into two discreet tiers within the governance contains a governance weakness in that it

- Makes the board legally responsible for leadership of the society when it does not necessarily contain the skills and competence for that role
- Gives the executives, who provide a substantial amount of the necessary skill and competence for these purposes, a lesser responsibility

Registration as a bona fide cooperative requires the constitution, amongst other things, to ensure that the members retain control of the society.

The introduction of independent commercially experienced people to support the board could help to address the skills gap in key areas, without compromising Cooperative Principles.

Should independent non-executive directors play a mainstream role in the governance of the Co-operative Group?

The board of the Cooperative Group currently gives a low rating to its effectiveness as a board. The absence of any independent directors is a weakness.

To comply with modern governance best practice, independent directors should play a part in the mainstream governance of the Cooperative Group.

The combination of independent directors and representative directors could improve on the company model and address some identified weaknesses.

The Co-operative Group as a hybrid society – federal and primary: corporate members, their role, right and expectations; conflict of interest in governance.

The Cooperative Group has changed from being an exclusively federal to a predominantly primary society.

Although its governance has evolved to rebalance the competing interest of individual and corporate members, it has not so far been structurally reviewed.

Currently, the governance arrangements build in systemic conflict of interest for representatives of corporate members carrying out certain functions on the Board.

This needs to be addressed, either by limiting those corporate members whose representatives can take part in governance in the relevant areas, or by delegation of issues giving rise to conflict to a level where the conflict does not exist.

An independent secretariat

The secretariat of a cooperative (within the traditional cooperative governance structure) needs to be independent of management. This requires that:

- the secretary is appointed and removed by the board
- the person appointed is of sufficient experience and calibre to stand up to the chief executive
- any executive responsibilities which are combined with the role of secretary do not undermine the independence from management.

Members and democratic structures

A new settlement is needed concerning the number of directors representing the Regions, and the number representing Corporate Members.

The United Region needs to be incorporated into the Cooperative Group's regional structure, and other than a need to strike an appropriate political settlement, there is no fundamental reason to adopt a radically different regional structure in terms of number of Regions and Areas, or boundaries.

Consideration should be given to whether there should be a reserved membership constituency for employees.

Consideration should be given to whether Regional Board and Board members should be directly elected by the members, and whether elections to the Board should be national

rather than regional elections.

Consideration should be given to whether the current federal General Meetings should be replaced by meetings open to Individual Members, or whether other measures should be explored.

The role of the elected representatives of members is to provide the link, in both directions, between members and those running the business; the link has to serve the purposes of communication, and accountability, so that the members retain their ownership and control.

“Control” does not just mean having the ability to hire and fire the managers. The 2nd Cooperative Principle makes it clear that members participate in setting their society’s policies and making decisions.

There are points at which members representatives are able to have a direct impact on some decision-making.

The structures between Individual Members and the Board should be designed to meet these needs.

There should be a clear decision on the most appropriate number of tiers in the governance structure.

The roles and responsibilities of Area Committees could be clarified, with more emphasis on them being the voice of the customer. This might be better achieved if they were less of a formal tier.

Part 1 – The Key Issues: A Driving Force for Reform

1. What Do The Co-operative Group's Stakeholders Think?

For the Review Board to appreciate the needs of all stakeholders within the Society, it is essential to first establish clearly how each group perceives itself. This task began with an exercise to establish what information already exists that is of relevance to the issues identified for the Review. We were able to draw upon a bank of relevant research into customer, member and elected member attitudes that have been of great use. Where gaps in knowledge were found, we commissioned a third party polling company, 'Stratosphere,' to undertake qualitative research to fill these gaps.

This strand of work sought to establish what each stakeholder group wants from their relationship with the Society. It is intended to gather the aspirations of members and clarify both the constitutional and real roles of the different stakeholders in the Co-operative Group.

Briefly, it considers the membership, the management and customers of the Group. It identified what stakeholders know about their role in the governance of the society and what those stakeholders want from their role in the governance of the society.

Third Party Polling

This research process has served to identify the:

- Perceived role and relevance of the Co-operative Group
- Key groups within the Co-operative Group's democratic structure, whose actions will govern the Group's future commercial performance
- Real sense of feeling within the business over the issue of governance reform and a desire for incisive reform
- Symmetry of views between all stakeholders

Those surveyed on a confidential and anonymous basis were drawn from the following stakeholder groups:

- Corporate Board Members
- Corporate Members (Non-Board)
- Executive Team
- Main Board Members
- Regional Board Members
- United Regional Council and MR Committee Members
- Area Committee Members
- Independent Non-Executive Directors (CFS)

Overall Findings

The key results of this work concerning the constitution can be captured in one word:

dissatisfaction.

Although there were differences of opinions on how things might be changed, the key area of dissatisfaction tended to be similar across the sample:

- The Main Board
- The Democratic Structure

In terms of the Board, the overwhelming view was that it was not currently fit for purpose.

- There was widespread belief that it was much too big. Most people hoped that it might be reduced to 12-15 in size.
- There was however less consensus about the make up of the Board, but the general sense was that as well as reducing the size, there should also be an increase in quality.

It should be noted that there was a significant groundswell of opinion in favour of substantive governance reform throughout the sample group and a desire to see this realised within months, as opposed to years.

The view from all key stakeholders was that the merger of the two societies to form a new Group offered a historic opportunity to turn around the fortunes of the movement.

It was felt that major constitutional changes were necessary to take advantage of this opportunity. The strong feeling from the research was that this opportunity should not be missed.

A number of tough messages with regard to the future of the Co-operative Group can be found in this polling and these are summarised below.

a) Opportunity cost

It was felt that after a long period in decline, the Co-operative Group had a major opportunity to turn around its fortunes and that constitutional changes were necessary to capitalise on new commercial opportunities.

b) Clarity of purpose within the Group

It was felt that the Group's development had been unplanned and that this had resulted in a complex organisation that was unable to meet its commercial challenges. Furthermore there were real fears that the necessary governance reform would be "fudged", leading to a period of relative decline.

c) Redesign the board and delineate its functions

There was almost unanimous belief that the Board was simply too big to perform effectively or for the individual members to contribute effectively.

Verbatim responses illustrate the strength of feeling here:

"The main Board is far too large and unruly and doesn't achieve much...being on the main board is quite boring. The worst day of my month."
(Corporate Board Member)

"The Board is far too big. You can't run a business with thirty three people." (IPNED)

"The Board needs to be stronger and more professional. I can't imagine running a business with twenty eight directors." (Area Member)

d) A need for leadership from the Review Group

Some recipients felt as the Society belonged to its members, then the CEO/Executives as employees should report to the Board but not be part of it. Also, some had historic Movement reasons for believing in separation: perhaps due to problems in the past when CEOs were included and became too dominant a force. The Review Group should deal with this as part of its activities.

e) Let's get the right talent on the Board!

The current process whereby people become directors through a process of representation by election was felt by some not to produce the calibre of people needed to run a business of

the current size and scale. In particular, it was felt that as representatives of particular constituencies (regions, societies) directors would tend to think of the interests of those constituencies. It was felt that at Board level this was an inappropriate way of thinking or position to be in.

f) *Let's set out a roster of rights and responsibilities*

There were differences of opinions about the role of members within the Group. No-one questioned their rights to ownership, or their rights to be involved. However, the key debate was in what way they should be involved. In essence, members believe they should be involved in running the business. The clear implication here is that the governance review should set out the respective roles of the key stakeholders in the Co-operative Group.

g) *Governance reform should boost democracy – in the interests of the business*

There were suggestions aimed at improving democracy through: national elections on a one person one vote basis; utilising traditional methods for informing choice (statements from candidates) and perhaps modern possibilities (web based, e-mails, forums, podcasts etc).

h) *A combination of interest groups in agreement on the need for change*

All stakeholders called for greater clarity and simpler structure, supported by greater clarity about roles and responsibilities (of the Board, of stakeholders, of members).

2. What is corporate governance and what is its aim?

This Review starts at the beginning, with a description of the key features of the corporate governance debate.

Meaning of corporate governance

“Corporate governance” is concerned with how a corporate entity is organised and controlled.

A corporate entity, such as a cooperative or a company, is an artificial legal person – that is to say, it has no physical existence (unlike human persons), but the law pretends it exists and treats it as if it was a real person. What does this mean?

Every person in our legal system is recognised by the law – that is to say, each of us¹ is allowed to own property, enter into contracts, sue and be sued. We have legal “rights”, and we can enforce those rights in a court of law because the law recognises us as persons.

The law also recognises corporate or artificial persons. Even though Tesco and Walmart do not actually exist in the physical world, they and other corporations can go to court to enforce their rights in just the same way as human persons.

However, a corporation being an artificial person can only do anything through human agents – people, or groups of people. The constitution of a corporate entity (amongst other things) basically describes those groups of people – who they are (directors, members, shareholders etc.), how you become one of them, and what their roles and responsibilities are. This is necessary so that those involved on the inside of the corporate entity know what their role is; and so that those on the outside know who do deal on behalf of the corporation (who has authority) for particular purposes.

¹ It was only in the 20th century that the law gave equivalent recognition to women as to men

All of this is written down in the constitution, and the constitution is the legal document which everyone can rely upon as describing how the corporation works, or how the corporation is governed. In addition to the constitution, different types of corporate entities develop ideas of good or best practice which supplement or go beyond what is written into constitutions. The Combined Code for companies and the Corporate Governance Code of Best Practice for cooperatives are examples of this.

Separation of ownership and control

At the heart of most corporate entities (including a cooperative and a company) is a separation of ownership (by members or shareholders) from control (by those in charge of running the business). In a simple corporation, the founders (members or shareholders) provide in the constitution for responsibility for running the business to be delegated to a smaller group of people, usually referred to as the board of directors. The directors are usually responsible for running the business on behalf of the members². They are rather like trustees of the corporation’s assets, and they are required by law to report back to the members every year explaining how they have used the assets (directors report and accounts). We would say that the directors have to account, or are accountable to the members.

The board of directors and the members are the two main groups of people (or “organs”) involved in the governance of a corporate entity³. Depending on the nature and size of the corporation, there may be other organs which have to be provided for within the constitution.

Most of the powers are delegated to the board of directors, and the members generally have a limited role to play in governance. In a company where the members are (often passive) investors, their role is usually confined to appointing/electing and removing directors,

² See, for example, Companies Act 1985 Table A article 70

³ In strict legal terms, it is the members meeting which is the organ of the corporation, rather than members individually.

approving any change to the constitution⁴ of the corporate entity, and appointing independent accountants (auditors) whose job is to assure the members that those in charge are telling the truth in their report on the finances of the business. In a cooperative, members share these same roles but they also play a greater role in the business with which they have an essential trading relationship (see further in the next section).

Corporate governance comprises what all of the organs of the corporate entity do, not just what the board of directors does. When designing or reviewing corporate governance, it is therefore important to consider the whole of corporate governance, not just part of it. Changing part without considering the whole can result in unforeseen consequences, and destabilisation of the very organisation itself.

Purpose of a constitution and corporate governance

Corporations are formed or come into existence for a purpose. People form *cooperatives* as a means of working together to provide a service for themselves and future members.

Companies are formed by their promoters as a means of generating a financial return for investors through some form of trade. This is effectively the “corporate purpose”.

Essentially, corporations are created to own or “hold” some kind of business; they are vehicles to hold and run the business so that the founders and subsequent owners are not exposed to personal liability if something goes wrong with the business. By creating a separate (artificial) legal person, the founders protect or insulate themselves⁵ against the commercial risks carried by the business. This is the concept of “limited liability”. It is the corporation and not the founders or owners, which owns the assets, enters into contracts, and carry on the trade, and it is therefore the

4 Including making any decision to merge with another entity – see for example Cooperatives UK’s 12th Edition Model Rules for a Consumer Cooperative (2007)

5 Except in rare situations where people deliberately use a corporate entity to hide from commercial risks, in which case the law does not allow the protection of limited liability to be effective.

corporation which carries the risks.

If the function of the corporate entity is to be the vehicle to hold a business, then the job of the constitution and the corporate governance arrangements is to make that vehicle as effective as possible. The aim is to ensure, as far as possible, that the intention of the founders and the subsequent owners (the corporate purpose) is achieved, through a successful business.

Governance arrangements and the constitution are therefore a means to an end. The objective is to deliver the corporate purpose by providing a vehicle to run a business.

Effective corporate governance

If corporate governance arrangements are to be effective, then they need to meet the needs of the business. This means fulfilling two basic requirements. The first requirement is that responsibility for the business is in the hands of people who are competent; competent to carry out the job assigned to them and competent to operate in the particular commercial environment given the competition involved.

Ensuring competence normally requires the appointment of properly qualified people. In corporate entities such as a cooperative where democratically elected representatives of members play a role, the balance between those appointed to manage the business and elected representatives is critical to the long-term survival of the corporate entity.

The second requirement is that there are appropriate arrangements amongst the people in charge of running the business (right size of board, appropriate composition, committees etc.) and appropriate arrangements to ensure that those who are responsible for running the business are appropriately accountable to the owners of the business. This means the owners having the power to appoint and remove the managers, and to play some part in strategic decision-making for the business.

Overly complex or bureaucratic arrangements, which impede effective and timely

decision-making, will make the business less effective. On the other hand, arrangements which do not sufficiently control decision-making exposes the organisation to risk. The governance arrangements therefore have to achieve a balance, and represent a compromise or settlement between ownership and control.

In finding out the needs of the business, it is necessary to listen to those responsible for the day to day management of the business. They are in the best position to describe or set out the needs of the business. However, it is **not their business**, and they must reach a settlement with those to whom the business belongs. Managers serve those who delegated authority to them, and ultimately their job is to deliver the objectives of the founders or owners for the time being.

It is for the owners to be clear about their objectives and the corporate purpose. This has been a real weakness in the cooperative sector over recent decades for many reasons (see the next section), as compared to the investor-owned or private sector where it has been entirely clear throughout. The Cooperative Commission played an important role in re-affirming the importance of commercial success in the context of cooperative trading.

Driving the business

One of the features of **effective governance** is that it does not just provide a corporate vehicle for holding a business; it should actually drive the business forwards, by containing its own mechanism of tension to drive the business to be more efficient and successful. This is best explained by example.

The company limited by shares is the most used corporate vehicle in the UK and many other jurisdictions. One of the reasons for this is that it is very effective. Its corporate purpose is to generate a return for investor-shareholders. In a company, the directors know that their job is to maximise shareholder value – to drive the business to be as profitable as possible. If they fail to do so, the shareholders will put pressure on them, and ultimately replace them if they are ineffective (i.e. enforcing accountability).

In other words, the company contains tension within its governance arrangements, and it is this tension which is the mechanism to drive its own efficiency and success. In the design of a company, the corporate purpose, the interests of shareholders and the power exercisable by shareholders are all in alignment. Consequentially, the model is “self-adjusting” and does not need any external agent to ensure that it sticks to or delivers its corporate purpose⁶. The shareholders will make sure that it does, and the law will back them up.

The company limited by guarantee, by contrast, does not normally contain the same mechanism to drive efficiency and success. Commonly, the directors are the members of the company. This means that there is no accountability, nobody driving the directors to perform well, or better. The model nevertheless works in some contexts, e.g. charities which wish to incorporate; but here there is an external agent to ensure that the corporation sticks to its corporate purpose – the Charity Commission.

There is no reason why a cooperative should not have similarly effective governance to a company limited by shares. Just as the shareholders of a company have an interest in making sure that the directors deliver the corporate purpose (a return on investment) so the members of a cooperative have an interest in ensuring that the managers deliver the cooperative purpose. But the governance structure of the cooperative needs to harness that tension in an effective way; and the cooperative purpose must be clear so that the managers have no doubt about what they are being asked to do.

It is important to bear in mind that another part of the driver of performance in listed companies is the market – the opportunity for change of control and take-over are very significant. The Listing Rules, with all their provisions for transparency and the continuing obligations of providing information (e.g. profit warnings) provide the basis for determining share price.

⁶ The shareholders fulfil this role. In the event of misbehaviour by directors, the courts will come to the assistance of the shareholders and enforce the corporate purpose.

Together, these arrangements serve to drive the performance of listed companies. There is no direct equivalent to the market for cooperatives. However, there is justification for making available to members, and the various membership structures, equivalent information to a comparable sized PLC, at least as promptly, to enable the membership structures to put pressure on management, and to back up independent directors.

In summary, effective corporate governance arrangements need to create a framework of constructive tension; through the accountability of those charged with running the business to those for whom the business is run. It is the tension and accountability which drives the business forwards. That framework needs to be clear, and agreed, and it needs to be operated and enforced on both sides.

Conclusions

Corporate governance comprises what all of the organs of the corporate entity do, not just what the board of directors does.

Corporate governance is a means to an end: delivering the vision of the founders of the corporate entity (the corporate purpose), by providing a vehicle to run a business, and limit the liability of the owners.

The overarching aim of corporate governance is to establish arrangements which

- **Meet the needs of the business**
- **Ensure that those responsible for the business are competent to do the job in the particular commercial environment**
- **Provide a framework of accountability to the owners**
- **Drive the efficiency and success of the organisation**

The prompt availability of appropriate trading information to the appropriate levels for members and members' representatives is needed to assist in driving such efficiency and success.

3. What does it mean to be a cooperative business?

A cooperative exists to be a provider of goods and services to its members, future members and other customers. It is distinguishable from other types of business because it is owned and controlled by its members⁷. But other than having a different ownership structure, what does being a cooperative business mean for the business itself?

For many people, *being a cooperative business* means that you do something different with the profits – instead of paying them to investors, you share them with customers, staff and local communities.

Indeed, it may not be unfair to say that during the last two or three decades, for many senior managers within the cooperative retail movement, doing something different with the surplus has been how they have seen cooperative trading. With the massive growth of the private retailers over that period, together with the wider political, commercial and cultural context, actually *being a cooperative business* has not exactly been a USP. During this period the harsh reality has been that survival of the business has been the focus of attention – survival against fierce competition.

The period witnessed a dramatic decline of market share (from 15% in 1977 to 5% in 2000⁸), though some credit should be given for still being there at all – even with a diminished asset base. By and large, it has been a long barren period, when management have wanted the least possible distraction from running the business; focus on profitability and stay alive. There has been little appetite and frankly little management time to think about what being a cooperative means, except in relation to what happens below the line. As a result, it has been a period when managers and democrats have

⁷ This is explored further in Section 3

⁸ The steepest decline (from 15% to 8%) was between 1977 and 1987 – figures from “The Cooperative Advantage”, the report of the Cooperative Commission

kept each other somewhat at arm’s length, with a rather uneasy stand-off: you leave us to run the business, and we will leave you to decide what to do with the surplus (“the old settlement”).⁹

The Cooperative Commission

The work of the Cooperative Commission published in January 2001 was a mile-stone. Its report bluntly stated the priority of commercial competence and financial success¹⁰ and set out a lengthy list of factors contributing to the under-performance of the business (see list at the end, from Chapter 1, paragraph 3.6 of the report).

It also brought to centre-stage the importance to the business of the cooperative ethos, in terms of building what it called “the cooperative advantage”. The concept of the virtuous circle was used: social goals giving the business a competitive advantage, leading to commercial success which could then deliver the social goals.

Whilst actively promoting the cooperative ethos as a means of driving the business was a very significant step forwards, there were some difficulties with the Commission’s message. First, cooperative managers, particularly after the bruising experiences of the previous two decades, did not really see their job as delivering social goals. Their job was to run a business, and if people started distracting management from maintaining a profitable business, there would be no business left. If “delivering social goals” was mainly concerned with delivering economic benefits to members (commercial success), or what happens below the line – using the surplus to support local communities¹¹, then this was less of a

⁹ It is recognised that this is a rough summary, and there are some notable exceptions. See also What is the relevance of membership in a modern consumer cooperative? Cliff Mills, Mutuo, June 2007

¹⁰ “Being a Cooperative is not an excuse for poor commercial performance” – Chapter 1, Paragraph 3.10

¹¹ “Commercial success must secure a balance of distribution of the surplus generated between the competing demands of reinvestment in the development of the business, the community dividend, and the individual dividend to continue the virtuous circle.” Chapter 1, Paragraph 7.2

distraction to management. In that sense, the Commission merely reinforced the “old settlement”. But the Commission’s social goals went further than that. The following were identified:

- Customer economic benefit
- Member benefit
- Employee stakeholders
- Ethical corporate culture
- Campaigning for the consumer
- Community investment
- Social enterprise initiatives
- Democratic participation
- Civic and community education

Much of this (apart from the first item) would not have been perceived by management as their core responsibility; furthermore, it would have been seen as difficult if not impossible to deliver from the current platform. The Cooperative Commission was effectively trying to redefine what it means to be a cooperative in the 21st Century – to redefine corporate purpose. In a sense, the Cooperative Commission was ahead of its time.

2001 – Today: the general picture

There have been dramatic changes since 2001.

The commercial market-place, as well as the wider political and cultural context have changed. The privately-owned retailers have continued to grow rapidly, and to expand into new sectors, but there is a noticeable change of public perception in relation to large and particularly dominant PLCs. Global warming, climate change and the plight of growers and producers, often from poor economies, have become more high profile issues at a popular level.

Whilst such developments might be thought to favour cooperative trading with its principled position in relation to such issues, the reality is that most large consumer-facing corporations now promote themselves as responsible corporate citizens, and are spending substantial amounts of money under their corporate social responsibility programmes on local communities, schools, and charities. Many would argue that such “public-spiritedness”

merely serves a commercial purpose. But the upshot of this is that it is no longer sufficient for cooperative businesses to say that they do good things with their surpluses; so does everybody else.¹²

If being a cooperative business simply involves doing something different and public-spirited with the profits and paying a bonus back to customers, then it is no different from a PLC business. There is no “cooperative difference” or cooperative advantage in this any more; everybody is doing it.

The current dilemma could be stated very starkly and somewhat dramatically: if what happens below the line can no longer be seen as what defines a cooperative business, then it either has to be defined by what happens above the line; or you have to start explaining why becoming a PLC is not the obvious next step.

The latter point is made to focus attention on the issue – nobody is suggesting this, but it illustrates the nature of the problem. However, if being a cooperative is to be defined substantially by what happens above the line, then this clearly raises some major challenges.

2001 – Today: the Cooperative Group

Many of the Cooperative Commission’s recommendations have been followed.

One area covered by the recommendations was the reinvigoration of the cooperative brand – not just in terms of discipline and visual identity and denoting quality, but developing the brand to take full commercial advantage of the movement’s ethos and trustworthiness. The Brand Panel settled on five Brand components. These components are: **consistent quality** – achieving minimal standards at least as good as the competition; **trust** – maximising the Movement’s reputation for trust

¹² There is a particular irony here. First, the idea of the cooperative dividend to customers was taken over by the private retailers, through their loyalty card. Then the cooperative tradition of supporting the local community, which dates back to the early days of cooperation, is adopted as well. In recent years, some retailers have now started copying the idea of being owned by customers (e.g. the “Your M and S”) campaign, suggesting (falsely) that the business somehow belongs to its customers.

and fair dealing; **rewarding experience** – ensuring that consumers and members feel that they have benefited from trading cooperatively; **community** – making strong relations with the community central to how the cooperative operates; and **championing** – making sure the brand stands for a distinctive ethical agenda.

The brand development was a major step forward in redefining what being a cooperative business means. It is not just what you do with the profits. It concerns **how you trade**; what are the underlying, guiding principles, and how you position yourself and are regarded by people in the market-place.

The Commission also made recommendations in relation to membership. By the end of the twentieth century, the role of membership seemed to have become largely irrelevant, and of questionable value to the business¹³. The Commission recognised that membership was not just the mechanism of ownership, but was also fundamental to the business of a cooperative. Its recommendations in relation to membership included ensuring that an increasing proportion of customers become members, and that an increasing proportion of the Society's business is conducted with members. There were further recommendations concerning the development of membership and ensuring that the full value to the business of membership is realised.

The Cooperative Group's membership proposition re-launched in September 2006 went a long way towards meeting the ambitions of the Commission. It is based upon four clear and concise statements: owned by our members; sharing the profits; supporting our community; and changing the world. These and the wider initiatives in relation to membership underpin the components of the Brand, and go a long way towards addressing what the Commission described as "Social Goals" set out above¹⁴.

¹³ See: What is the relevance of membership in a modern consumer cooperative? Cliff Mills, Mutuo June 2007

¹⁴ See Re-launching the Cooperative Group's Membership Proposition – Masters of Management

These developments have created a significantly different platform today for the Cooperative Group. Together, they represent very substantial progress in developing a trading proposition based upon being a cooperative, underpinned by a membership strategy designed to further the corporate purpose and add value to the business. The creation of a Group Marketing function with responsibility for brand, membership, social goals and customer relationship marketing supports this.

Essentially, these developments go a long way towards articulating a corporate purpose for the 21st Century, and describing what it means to trade as a cooperative.

Where next?

The Constitutional Review seeks to come up with new governance arrangements appropriate for the Cooperative Group in the 21st Century. As explained in the previous section, corporate governance is a means to an end, namely delivering the corporate purpose. In order to design effective arrangements however, the corporate purpose needs to be clear, and agreed.

Being clear about the corporate purpose has been a problem for the retail movement in recent decades. This has put it at a distinct disadvantage against competitors, leaving managers wanting just to concentrate on profitability, rather than having to follow some principles which appear to have limited relevance to trading.

The work of the Cooperative Commission and the implementation of a number of its recommendations by the Cooperative Group create a different environment today, with a clearer idea of the relevance to the business of being a cooperative, and being owned by members rather than investors. There is an attempt to summarise the corporate purpose at the end of this section.

However, having a corporate purpose which is itself a potential USP in the market-place is of

limited value unless the governance supports the business in seeking to meet the objectives. From the membership to the Board, and from local stores to the head-office, the governance at every level must add value to the business if the governance is going to be most effective. Unless it does so, those running the business will be held back and at a disadvantage against the competition. However, managers also have to accept that being a cooperative brings with it ownership arrangements **which do impinge on governance** in a way which does not occur in a PLC. A compromise has to be found at each level.

Trading as a cooperative means first and foremost providing a service. Therefore managers' first priority is always to trade profitably; unless they do this, they cannot continue to provide the service. However in strategic planning, in the policies to be followed in carrying on business, and in making certain specified decisions, managers have to operate within the established values and principles, and accept that at certain points, their governance is different from a PLC.

A new settlement is needed.

Conclusions

Being a cooperative business is not simply a question of what the business does with its profits.

A cooperative is owned and controlled by its members, and exists to provide goods and services on a cooperative basis to members and other customers.

The central message of the Cooperative Commission, and the implementation by the Cooperative Group of a number of its recommendations on brand and membership go a long way towards articulating what it means to trading as a cooperative in the 21st Century.

Being profitable remains the pre-requisite for survival and the principal focus of management. But being a cooperative business, and having that unique selling point in the market-place, brings with it the need for managers to accept that the ownership and governance structure are different from a PLC.

The ownership and governance structure should be designed (re-designed) to add value to the business at every level, and not to impede it.

What the Commission Concluded

The main factors, not necessarily in order of importance and not present together in all cases, leading to the under-performance of a substantial section of the Cooperative Movement – Cooperative Commission Chapter 1, paragraph 3.6

- Inadequate strategic direction of businesses by Societies' Boards
- Lack of quality management and inadequate employee training
- An inability to motivate and involve Cooperative Group employees fully in Cooperative Group businesses
- Concentration on meeting social goals at the expense of, or without reference to, commercial performance
- Unwillingness to take commercially necessary decisions, e.g. closure of perennially loss-making activities.
- Failure to innovate in terms of products, services, or organisation.
- Failure to adopt modern, successful marketing methods and practices.
- Failure to keep pace with business sector competitors.
- An inability to take advantage of the cross-selling potential of the Movement as a whole
- An as yet unfulfilled potential of the Movement to communicate its capability to respond to developing consumer demands for trust and social concern in the delivery of goods and services.
- Failure to measure and set clear goals for both commercial and social performance.
- Lack of the active involvement of properly informed members in the affairs of the Cooperative Group business.
- Lack of pressure on management and Boards for change.
- Lack of focus on commercial performance.
- Reluctance to change poor management or recruit new management externally.
- Fragmentation of the Movement.
- Lack of cooperation between Societies.

Being a cooperative in the 21st Century - a summary

The Theory

The Practice

<ul style="list-style-type: none"> • Society exists to provide a service to members and customers by trading as a cooperative. 	The society must be financially successful and profitable to survive, else it can never achieve its purpose
<p>This means</p> <ul style="list-style-type: none"> • being owned and ultimately controlled by members, membership being open to anybody 	Being owned by individuals who are customers or staff of (i.e. trade with) the society, rather than by investors, underpins the corporate purpose, and is designed to ensure that it fulfils its purpose
<ul style="list-style-type: none"> • actively challenging and competing with conventional, privately-owned businesses by 	USP – the cooperative difference
<ul style="list-style-type: none"> o what it is, and 	USP - being a cooperative, owned and controlled by its members, and
<ul style="list-style-type: none"> o how it trades 	USP - trading guided by values and principles
<ul style="list-style-type: none"> • trading on the basis of values and principles which focus on the common good, rather than private gain 	In carrying on business, it acts differently from PLCs because it follows some values and principles. However, it exists to trade, and the Vs and Ps (and “social goals”) inform how it trades.
<ul style="list-style-type: none"> • having governance arrangements which support the corporate purpose, and add value to the business 	Governance is a means to an end, and should be aligned with the ownership structure and corporate purpose.

4. Cooperative corporate governance

Section 2 reached the conclusion that corporate governance comprises what all of the organs of the corporate entity do, not just what the board of directors does, and that corporate governance is a means to an end, not an end in itself. It also concluded that the overarching aim of corporate governance is to establish arrangements which meet the needs of the business, to ensure that those responsible for the business have the necessary skills and experience to do the job, to provide a framework of accountability, and to drive the efficiency and success of the organisation .

Section 3, about what it means to be a cooperative business, concluded (amongst other things) that a cooperative exists to provide goods and services on a cooperative basis to members and other customers; that being a cooperative business means being owned and democratically controlled by members; and that the ownership and governance structure should be designed (re-designed) to add value to the business at every level, and not to impede it.

So the next question is: what factors need to be taken into account in designing a governance structure appropriate for the Cooperative Group in the 21st century?

The question will be considered in two parts: issues affecting those parts of the governance linking the membership to the board, including regional boards, area committees, regional councils and member relations committees will be considered in section 8. That part of governance involving the board and management will be considered here.

At the heart of this is an even sharper question: how do you combine competence (having the necessary skills and experience) in running a business with democratic accountability? How do you design the interface in the governance

between professional executives, and elected representatives of members?

Controlling and running a corporate entity

The starting point is to consider what is involved in controlling and running a corporate entity. As explained, in section 2, the members of a corporate entity delegate to a small number of people responsibility for running the business, and then take a step back and reserve to themselves limited rights.

Responsibility for running the business

is dealt with and divided up in different ways within different corporate entities, but a more or less common principle is that a chief executive, heading a management team usually on some kind of pyramid structure carries day to day responsibility for running the business. Management are employed by the corporate entity; they are selected for their professional skills and experience, and remunerated accordingly. Because they are the people with the specialist skills to run the business, common sense and good practice dictates that they should do precisely that.

The area which we are mainly concerned with at this stage is that part of “responsibility for running the business” which is outside and fits round the role of management; it is the part that holds management in check (or accountable) and makes sure it is doing its job; and it is the part which gives strategic direction to and takes ultimate leadership responsibility for the corporate entity.

In a conventional company, it is the part played by the board of directors, comprising both executive and non-executive directors. The Combined Code on Corporate Governance¹⁵ states as the main principle in relation to the board that “Every company should be headed by an effective board, which is collectively responsible for the success of the company.” The role of the board is then set out as follows:

The board’s role is to provide entrepreneurial leadership of the

¹⁵ The Combined Code on Corporate Governance, July 2003 on the FSA website at http://www.fsa.gov.uk/pubs/ukla/lr_comcode2003.pdf

*company within a framework of prudent and effective controls which enables risk to be assessed and managed. The board should set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives and review management performance. The board should set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met.*¹⁶

The board does not actually run the business – that is management's job. The board provides the entrepreneurial leadership within a framework of controls; sets the strategy, ensures resources are in place for the business, and reviews management's performance. It is also responsible for setting values and standards, and ensuring obligations to stakeholders are met.

The Combined Code is dealing with companies and saying that for companies, these tasks together make up the role of the board. The division of responsibilities within the Cooperative Group and other large retail cooperatives is different; however, the Combined Code tasks which make up the role of the board are generic, and have to be covered somewhere within cooperative governance. A cooperative operates under a different legal framework, and that has some impact here.

Compliance with the law

Registration as a cooperative with the Financial Services Authority is only possible if the FSA is satisfied that a society is a bona fide cooperative¹⁷. It can cancel a registration if it appears that the society no longer complies with the conditions of registration.

The FSA publishes information notes, one of which sets out the conditions which a society will normally have to fulfil if the FSA is to be

¹⁶ Section 1 Companies, A.1 The Board – Supporting Principles

¹⁷ Section 1 (2) (a) Industrial and Provident Societies Act 1965

satisfied that it is a bona fide cooperative. Broadly, these conditions reflect the ICA's Statement of the Cooperative Identity. The relevant condition for present purposes is the one headed "Control" which states as follows:

Control of the society lies with the members. It is exercised by them equally and should not be based, for example, on the amount of money each member has put into the society. In general, the principle of "one member, one vote" should apply. Officers of the society should generally be elected by the members who may also vote to remove them from office.

In a small society, the members elect a committee or board, who would normally employ a manager to run the day to day business. The board might play a significant role in running the business, leaving less discretion to the manager. However, in the large retail societies including the Cooperative Group, the rules expressly provide that the day to day running of the business is delegated to a professional executive, and it is generally accepted that the board keeps out of the day to day business¹⁸. The board remains responsible for determining strategy, hiring and firing the chief executive, and monitoring the chief executive in delivering the strategy.

This two-tier approach of separating strategic from operational management is accepted by the FSA. Although the elected officers do not run the business (they may not/do not have the necessary skills to do so), by retaining the power to fix strategy, and hire and fire the chief executive, they are deemed to retain control.

The complete separation between board and executive (no executives are on the board, and board members are not part of the executive) is accepted by the FSA as complying with the law but it has no known parallel in any other corporate structure of comparable scale. It means that the only forum in which strategic decision making takes place is one where the executives do not share legal responsibility;

¹⁸ Refer to the relevant provision of the Code of Governance

and it creates a rather polarised and potentially oppositional environment between members, elected representatives and management.

Of course, a number of large UK cooperative retail businesses have operated with this arrangement for a number of years, and it cannot be definitively stated that it does not work; however that is not the point. The question is whether it is the best arrangement for the business, or whether it is in the best interests of the society and its members that it should continue.

The Cooperative Commission

The report of the Cooperative Commission considered this issue, recognised that the chief executive “plays a major role in the operation of the Board”, and was concerned that the current “ad hoc” arrangement may not place on the chief executive the same fiduciary responsibility as the elected directors¹⁹. From the working papers, it can be seen that the Commission looked at other governance models, but fell short of recommending any radical restructuring of cooperative governance.

The Commission ended up recommending a way forwards which none of the leading societies have subsequently followed. It recommended that the chief executive and financial controller (as a minimum) should serve on the board and be seen to share the same fiduciary responsibility as the elected directors.

The governance weakness

The basic problem with current co-operative governance is that it comprises a governance weakness. A great deal of power resides in the executive team who are effectively left in full control of the business. The consequence of this is that the board is arguably not really in control of the business. It carries the legal responsibility, but does not have the necessary power to discharge it. It retains the right to determine strategy, and to play a part in matters brought before the board, but it does not control the business. Aside from reporting to the board on a monthly basis, the executive do this largely unchecked.

¹⁹ Chapter 4, paragraph 2.4 the Cooperative Advantage

This is very different from a company. In a company, the board actually retains full control of the business, and appoints executives to whom the board delegates their executive responsibility. ***In the company model, the directors retain full (personal) legal responsibility for the running of the company.*** Consequently, in a public limited company²⁰, all board members are expected to have the requisite skills and experience to carry such responsibility; they are remunerated accordingly; and it is in the best interests of the owners of the business and of achieving the ultimate corporate purpose.

The weakness in the current model of cooperative governance is that the board, being an elected body, is ***not designed to contain the necessary skills and experience to carry the full legal responsibility for the society;*** and yet it is the sovereign legal body within the organisation and therefore ***does carry that responsibility.*** A great deal of the necessary skills and experience to carry the legal responsibility resides with the executives: but they are constitutionally separated from the board, and at least on the face of the rule-book, do not appear to carry the same level of legal responsibility.

Should the issue ever be tested in litigation, a court may well decide that the executives ***do carry*** a high level of legal responsibility, but that would not necessarily absolve the board members of their legal responsibility. Effectively, the senior executives are shadow or de facto directors of the society, even though they are not formally members of the Board under its constitution. In short there is a weakness in the design of the governance here. With an organisation of the size and complexity of the Cooperative Group, such a weakness should be addressed. Governance weaknesses expose the corporate entity to risk, and then come under scrutiny in litigation following corporate disasters.

The Equitable Life case is an object lesson here. Serious problems of corporate

²⁰ In a private company, it is up to the shareholders what they do and who they appoint.

governance lay at the heart of Equitable's failure, and in his report, Lord Penrose had the following damning comments to make about lack of board control and competence:

The Board at no stage got fully to grips with the financial situation faced by the Society: information was too fragmented, their collective skills were inadequate for the task, and there were no effective arrangements for ensuring that there was detailed examination of, and onward reporting to the Board on, actuarial reports. Equitable's non-executive directors were so wholly dependent on actuarial input from the executive and in particular from the chief executive/actuary that they were largely incapable of exercising any influence on the actuarial management of the Society.²¹

Lord Penrose's report specifically identified issues in relation to the constitution of the Society in that new appointments to the board were in the hands of other board members, such that it was a "self-perpetuating oligarchy amenable to policyholder pressure only at its discretion"²². Nobody could accuse the Cooperative Group of being a self-perpetuating oligarchy, but it remains open to a similar weakness in effect in that the governance is not designed to produce office-holders whose competence is guaranteed, such that members can be sure that they will provide an effective (and appropriately independent) challenge to the executives.

Arguably the area of greatest risk to the Cooperative Group is in relation to the audit committee. From the point of view of the members, the audit committee of a corporate entity plays a key role in ensuring the integrity of internal controls, and accurate financial reporting. The Combined Code recommends that all members of the committee should be independent non-executive directors, and that at least one member has recent and relevant

²¹ The Report of the Equitable Life Inquiry, The Right Honourable Lord Penrose, the House of Commons, 8th March 2004: Chapter 20 paragraph 50.

²² Chapter 20, paragraph 51

financial experience. Such experience would be expected to be a professional qualification from one of the professional accountancy bodies. The Cooperative Group has no independent non-executive directors, and none of the directors appear to be members of a professional accountancy body. The fact that those with significant business executive experience are themselves executives of corporate member societies renders their experience of limited value – they might be unlikely to expose, for example, evidence of bad practice if such practice was followed within their own society.

In recommending new governance arrangements to members, the Board of the Cooperative Group owe members a duty to put forward arrangements which will be in the best interests of members and the society as a whole, and address any basic governance weaknesses.

Maintaining members' control

If the current arrangements do not provide the best and most robust governance arrangements, how much freedom is there within the law to change things, and what alternatives are possible?

The FSA takes a pragmatic approach, and as a financial regulator has a clear interest in supporting societies, particularly large high profile societies, in having robust governance. For example, it has never questioned the principle that rule-books should clearly state that appointed executives should be responsible for managing the day to day business²³. The needs of the business require that skilled professionals should do this job.

Under the current arrangements, the members retain control because their elected representatives, the board, remain responsible for determining strategy, hiring and firing the chief executive, and monitoring the chief executive in delivering the strategy. On this basis, the two-tier approach of separating strategic from operational management is

²³ First introduced in the rules of United Norwest in the mid 1990s, this was introduced into the Cooperative's rules after the merger with CRS

accepted by the FSA.

There is no reason why the elected representatives should not continue to play a role in determining strategy – indeed they should do. It is effectively a job carried out jointly with the executives, whose skills and experience are needed to ensure that the strategy is realistic and deliverable. The board's role here, however, is fundamental in ensuring that the strategy is a cooperative one, and it is responding to the needs and aspirations of the members whom they represent. Having the members influencing strategy is fundamental to being a cooperative business. The cooperative principles require that members actively take part in setting policies and making decisions²⁴.

The ability to hire and fire (and fix the remuneration of) the chief executive also seem to be an essential part of member control. However, it is such a critical decision, and cooperative boards historically seem to be so reluctant to replace chief executives that there is an argument for saying that although elected members must have the final say in this, they need the support and advice of others with independent commercial experience – not just in recruitment, but in potential removal of the chief executive as well.

This then links into the third role – monitoring the performance of management. As already stated, an elected board is not designed to guarantee that it will contain the competence and experience which are necessary to discharge this function. Furthermore, the separation of board from executive makes this function more difficult. Here again, elected representatives need additional support.

If the members' elected representatives need the assistance of independent commercially experienced people to support them in discharging this function, provided that the members' elected representatives appoint and remove such independent persons who remain accountable to them, then there is no reason why that should be seen by the FSA as an erosion of members' control. Indeed it is

24 ICA Statement on the Cooperatives Identity – 2nd Principle: Democratic Member Control

arguably an increase in members' control, because it means having people with specific competence doing a job on their behalf, which should be more effective.

The introduction of independent people ("non-executive directors") into the governance of the Cooperative Group is considered further in section 5. It is suggested that this could be a way of addressing the governance weaknesses in the current structure.

Conclusions

The separation of board and management into two discreet tiers within the governance contains a governance weakness in that it

- **Makes the board legally responsible for leadership of the society when it does not necessarily contain the skills and competence for that role**
- **Gives the executives, who provide a substantial amount of the necessary skill and competence for these purposes, a lesser responsibility**

Registration as a bona fide cooperative requires the constitution, amongst other things, to ensure that the members retain control of the society

The introduction of independent commercially experienced people to support the board could help to address the skills gap in key areas, without compromising Cooperative Principles

5. Should Independent Professional Non-executive Directors play a mainstream role in the governance of the Cooperative Group?

Non-executive directors in companies

The concepts “executive director” and “non-executive director” originate in companies. UK companies use the model of a unitary board containing both executive and non-executive directors, and the board of directors as a group carries collective responsibility for running the business and affairs of the company. They do so for the benefit of the company and its owners (shareholders), not for their own benefit. This is the principal of “shareholder primacy”, and their responsibility for managing somebody else’s assets or resources is usually referred to as the “agency theory”. The problem is that the separation of the ownership of resources from the management of resources, which is inherent in the agency theory, gives rise to an inevitable conflict of interest.

It became common in the 1970s and 80s for public companies (PLCs) to reward their executive directors with share options and other rewards tied to the financial performance of the company. It was therefore in the personal interest of executive directors to promote current year profitability, and today’s share price, and to ensure that the financial accounts showed the company’s financial position in the most favourable light. Institutional shareholders (principally pension funds and insurance companies) who controlled a large proportion of investment in listed PLCs started to press for and require the presence on boards of independent non-executive directors. Their role was to be objective, and independent of management, and to ensure that the interests of shareholders were properly protected.

The typical PLC non-executive director was a seasoned business professional, who could operate at the same level of commercial understanding as the executive directors. By 2001, non-executive directors were prevalent in

the UK, and in the US, some 75% of companies listed on the New York Stock Exchange and the NASDAQ stock exchange had majority independent boards. Then came Enron, and a series of massive corporate governance failures which caused wholesale reappraisal of the role of non-executive and independent directors.

Federal reform in the US via the Sarbanes-Oxley Act of 2002 was followed in the UK by the Higgs report of 2003. There was a focus on the role of the board, of the chairman, and of non-executive directors, the emergence of clearer views about “independence”, and the recruitment and appointment of board members. A number of other areas were also considered which are beyond the scope of this piece, but they included induction and training, tenure, remuneration, audit and remuneration committees, and relationship with shareholders.

Key recommendations (now incorporated into the Combined Code²⁵) include:

- The board is collectively responsible for promoting the success of the company by leading and directing the company’s affairs (see the description of the role of the board incorporated into the Combined Code at the end of this section)
- At least half the members of the board, excluding the chairman, should be independent non-executive directors. There should also be a strong executive representation on the board
- A description of the role of the non-executive director is proposed for incorporation into the Code (see end of this section). This includes constructively challenging and contributing to the development of strategy, scrutinising the performance of management, and satisfying themselves that financial information is accurate
- All directors should take decisions objectively in the interests of the company
- A definition of independence is proposed for incorporation into the Code (see end

of this section), which precludes representation of a significant shareholder

These reforms represented a significant shift in thinking. Non-executive directors were now not just independent of management, but of individual shareholders as well. They had become more like protectors of the corporate purpose of the company, rather than representatives of a different interest group from management.

The cooperative context

Companies are substantially different from cooperatives.

A company's reason for existence, or corporate purpose, is to make a return for its investor shareholders. A company is owned by those investor shareholders, and their primary and often only relationship with the company is one of ownership. A cooperative's reason for existence, or corporate purpose, is to provide a service, on a cooperative basis, to its members (membership being open to anybody). Although a cooperative is also owned by its members, their primary relationship with the society is one of mutually beneficial trade.

The governance arrangements for different types of corporations are designed to suit the type of corporation, its corporate purpose, and its form of ownership (see section 2). Those governance arrangements are merely a means to an end: to provide the most effective vehicle for holding a business, so that it is most likely to achieve its corporate purpose and its owners' aims and objectives.

When moving from one type of corporation (such as the company) to another (such as a cooperative), it is important not just to "read across" the governance tools and devices. Instead, what must be considered are the purposes for which those tools and devices are deployed, and then to consider the appropriateness of their use in the different context.

The Cooperative Group, like other large UK

retail cooperatives, has a two-tier structure which splits legal responsibility for running the company between a board elected by members, and an appointed executive. The necessary skills for running a large and complex business on a day to day basis reside with executive management. The board (which also includes elected representatives of corporate members who are themselves executive managers of other retail societies) are broadly responsible for determining vision and strategy, appointing and removing the chief executive, and overseeing the chief executive and management.

There is a power for the board to appoint "professional non-executive directors" to the governing body of any other member of the Group, and this power has been exercised to appoint independent non-executive directors of Cooperative Financial Services, to meet regulatory requirements in the financial sector²⁶. There is no power to appoint professional non-executive directors to the board of the Group, under the transitional post merger rules.

Currently, the Cooperative Group does not have any directors who would be regarded (in Combined Code or company terms) as independent²⁷. All of them are elected in either regional or corporate elections. They therefore represent (and are intended to represent) a constituency and by definition are not independent. There is a strong argument that such individuals contribute something of value which is missing in the company model (see further below). But the absence of any independent directors must be regarded as a weakness to be addressed. On CFS however, the FSA has accepted that the Regional Directors are classed as independent, in line with the Code.

In particular, the absence of independent directors with the specific skills (and governance responsibility) to undertake some of the important tasks allocated to non-executive

²⁶ Rule 98

²⁷ The Corporate Governance Code of Best Practice published by Cooperatives UK does not recommend the introduction of independent directors; it recommends that the matter should be left to the board and members of each society (paragraph B2.5).

directors in the Combined Code exposes the Cooperative Group to risks. In other sectors, independent directors are carefully chosen for their particular skills and experience, to do a particular job. The lottery of democracy, with its lack of any pre-qualification based on skills and experience, cannot possibly be expected to produce individuals with the necessary ability to discharge onerous functions. Elected directors cannot currently be seen as discharging the role of independent non-executive directors.

It is understood that the board has given itself a low rating in assessing its effectiveness. One of the sources of difficulty is the size of the board which at 33 is well above recommended levels and patently too large (even if reduced to between 20 and 30) to be effective in its current role. This is an issue to be addressed.

The introduction of independent directors into the mainstream governance of the Cooperative Group should be considered as a priority. However, it is not a panacea, and of itself is insufficient. Other associated changes of structure and procedure need to be introduced to secure the benefits, including in relation to audit, and remuneration committees.

It is interesting to note that the introduction of independent non-executive directors into the mainstream governance of the Cooperative results in the presence of three elements in the governance: management, elected directors²⁸, and independent directors. Typically there are two, as in companies (management and independents), which can either be oppositional where relationships are poor or break-down, or ineffectual where they become too cosy. The involvement of three elements may address some of the weaknesses recognised by academics and commentators in the company model. It is helpful that the feed-back to date on the experience on the board of Cooperative Financial Services is positive.

Conclusions

The board of the Cooperative Group currently gives a low rating to its effectiveness as a board.

The absence of any independent directors is a weakness.

To comply with modern governance best practice, independent directors should play a part in the mainstream governance of the Cooperative Group.

The combination of independent directors and representative directors could improve on the company model and address some identified weaknesses.

²⁸ It is recognised that representatives of members comprise corporate and regional representatives

Higgs Chapter 4 - The role of the [unitary] board

The board is collectively responsible for promoting the success of the company by directing and supervising the company's affairs.

The board's role is to provide entrepreneurial leadership of the company within a framework of prudent and effective controls which enable risk to be assessed and managed.

The board should set the company's strategic aims, ensure that the necessary financial and human resources are in place for the company to meet its objectives, and review management performance.

The board should set the company's values and standards and ensure that its obligations to its shareholders and others are understood and met.

Higgs Chapter 6 – Role of the Non-Executive Director

Strategy: *Non-executive directors should constructively challenge and contribute to the development of strategy.*

Performance: *Non-executive directors should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance.*

Risk: *Non-executive directors should satisfy themselves that financial information is accurate and that financial controls and systems of risk management are robust and defensible.*

People: *Non-executive directors are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary removing, senior management and in succession planning.*

Higgs Chapter 9 – Independence

A non-executive director is considered independent when the board determines that the director is independent in character and judgement and there are no relationships or

circumstances which could affect, or appear to affect, the director's judgement.

Such relationships or circumstances would include where the director:

- *is a former employee of the company or group until five years after employment (or any other material connection) has ended;*
- *has, or has had within the last three years, a material business relationship with the company either directly, or as a partner, shareholder, director or senior employee of a body that has such a relationship with the company;*
- *has received or receives additional remuneration from the company apart from director's fees, participates in the company's share option or a performance-related pay scheme, or is a member of the company's pension scheme;*
- *has close family ties with any of the company's advisers, directors or senior employees;*
- *holds cross-directorships or has significant links with other directors through involvement in other companies or bodies;*
- *represents a significant shareholder; or*
- *has served on the board for more than ten years.*

The board should identify in its annual report the non-executive directors it determines to be independent. The board should state its reasons if a director is considered to be independent notwithstanding the existence of relationships or circumstances which may appear relevant to its determination.

6. The Cooperative Group as a hybrid society – federal and primary: corporate members, their role, rights and expectations; conflict of interest in governance

The Cooperative Group as a federal body

The Cooperative Group was formed by independent retail societies in 1863 as the Cooperative Wholesale Society. Its role was to be a wholesaler, and for a significant period of its life it was also a manufacturer, supplying its corporate members. From time to time it has also provided other services to its corporate members which could more conveniently and effectively be provided at federal level.

Until 1973, the Cooperative Group was entirely owned by societies or corporate members. The ownership and governance structures were designed on this basis, and provided for representatives of corporate members to make up its board. This was logical and appropriate, enabling corporate members to maintain control of the business which was conducted entirely for their benefit.

In 1973, the Scottish CWS transferred engagements to the Cooperative Group, as a result of which for the first time, the Cooperative Group had individual members. This arose because by 1973, SCWS had become a hybrid federal/primary cooperative as a result of a number of ailing primary societies having transferred engagements to it in the past. Subsequently, a number of primary societies transferred engagements to the Cooperative Group, the most recent being CRS in 2000, and United in 2007.

The effect of these transfers of engagements was that the Cooperative Group moved from being originally an exclusively federal body, through being partially federal and partially primary, to now being a predominantly primary society. This can be illustrated from its current trade, approximately 75%²⁹ of which is through

29 These figures are currently still being debated and

its primary retailing and other consumer-facing businesses, and approximately 25% of which is with its corporate members. As these changes to its business have taken place, they have been accompanied by changes in its formal ownership and governance structures as set out in its rules. For individual members, this was structured through geographical regions reflecting the society's national membership, and traditional cooperative shareholding via £1 shares³⁰. For corporate members, substantial shareholding is permitted under the current rules, based on £5 corporate shares.

At board level, the composition has moved from entirely comprising representatives of corporate members, to being now predominantly made up of representatives of individual members (a board of 33, the proportions being 25:8). In that sense, the changes to the governance have kept pace with the changes in the underlying business. However, in overall structural terms, the governance has not changed to meet the needs of the business, and this is causing significant issues as is discussed below. First, however, it is appropriate to consider the current role of corporate members.

The role, rights and expectations of corporate members

Corporate members currently hold £15.3 million of corporate shares, and individual members hold £40.4 million of individual shares³¹. Under the Cooperative Group's rules³², corporate shares are transferable, but not withdrawable, and carry the right to interest at a rate (which may be 0%) to be determined by the board. Neither corporate nor individual shares carry the right to vote – voting being determined by purchases from the society. Neither corporate nor individual shares carry the right to any entitlement to a capital surplus in the society's assets on a solvent winding-up – such

should be treated as a guide only.

30 The current strategy in relation to individual shareholding is to limit it to £1. A mass membership proposition whereby single application processes are required which do not contravene the code of practice on withdrawable share capital, which provides important exemptions from money laundering regulations etc.

31 Figures taken from the 2006 accounts, which do not reflect the transfer of engagements by United.

32 Rule 47

assets being transferred to another society in membership of Cooperatives UK.

Under its rules, the Cooperative Group is obliged in its federal role to use its best endeavours to co-ordinate the requirements of corporate members for goods and services, and then meet those needs on the best possible terms³³. Corporate members, in turn, are required to provide the Cooperative Group with details of sales, stocks of goods and receipts of services, and to purchase from the Cooperative Group such of its requirements for such goods and services as the Cooperative Group is able to provide or procure.³⁴

In practice, the Cooperative Group's role as a federal body is now mainly restricted to its function in running and operating CRTG, and, since the transfer of engagements by United, CTTG as well. However, from the corporate members' point of view, they regard themselves as having a share of the ownership of the Cooperative Group, its business and heritage, and of what now comprises the movement's largest asset. Although they collectively hold significant share capital, its value is limited to the nominal value, though the expectation of a corporate dividend remains a significant factor.

Conflict of interest

As indicated above, there is one area where the governance of the Cooperative Group has not changed to keep pace with the changes to the underlying business, namely the structural arrangements for the governance of the Cooperative Group. Originally, there was no problem with representatives of corporate members serving on the board of an organisation whose business was conducted entirely for their benefit. However, now that a greater proportion of the business is conducted for the benefit of individual members and customers, a problem arises. That primary business is essentially the same line of business as that conducted by corporate members, with the result that in principle the Cooperative Group is in competition with its corporate members. Although in practice actual competition is relatively limited, it is

33 Rule 13

34 Rules 14 and 15.

nevertheless significant, particularly in considering acquisitions of businesses. The issue becomes manifest within the board, where a representative of a corporate member may experience a conflict of interest. The law is relatively straightforward³⁵. A director of a corporate entity owes to the corporation a fiduciary duty, or duty of good faith, always to act in the best interests of the corporation of which they are a director. This duty of "undivided loyalty" requires directors to keep its affairs confidential, and not to put themselves in a position where their duty as a director conflicts with any other duty. Where an occasional or accidental conflict does arise, they are normally required to declare it, and withdraw from the matter under discussion³⁶. Otherwise, they will find themselves in an impossible position where they are in breach of duty to one organisation or the other.

In its original role as a federal society owned by corporate members, conflict of interest in relation to the core business would be relatively rare. However, once the greater part of the Cooperative Group's trade was as a primary society, conflict of interest was bound to become a problem because it is systemic, not accidental. Governance arrangements designed for a federal context are unsuitable in a primary context. This structural issue has not previously been addressed.

Where next?

Governance arrangements should be designed to suit the circumstances, as explained in section 2. How, therefore, should having corporate members impact on designing the governance for the future?

Corporate members have a significant stake in the Cooperative Group, both in terms of share capital invested, and volume of trade with the society. However, it is fair to say that their main interest in the Cooperative Group is in its federal role, namely in relation to CRTG and CTTG. It seems appropriate that corporate members should have a proportionate interest in the

35 It is helpfully summarised in the note of conference with Christopher Nugee QC, annex 6 in the report of the Cooperative Commission.

36 Rule 139 contains this type of provision.

governance in those areas.

Given the conflict of interest problem, and given also that corporate members are not directly involved as corporate members in the primary trading of the Cooperative Group (individual members have that involvement), subject to two important qualifications, it seems less clear that corporate members should have a similar level of representation in the governance of the primary businesses. The two qualifications are as follows:

- Representatives of corporate members are usually chief executives or senior executives of their own society. As such, they may well bring to the governance of the Cooperative Group's valuable experience and expertise.
- As part owners of the society, corporate members have a legitimate claim to an entitlement to be involved in the governance, all other things being equal.

As to the first point, with a declining number of corporate members, the relevant experience and expertise they can offer will similarly decline. If independent non-executive directors are introduced, this could provide an alternative source of expertise.

As to the second point, all other things are not, of course, equal. Conflict of interest creates a serious problem which needs to be addressed. Except in relation to corporate members whose society's own corporate strategy effectively ensures that they are not in competition with the Cooperative Group, it would seem that the continuing involvement of corporate members in the direct governance needs to be reviewed.

The final point to make is that, depending upon the overall governance structure eventually adopted by the Cooperative Group, it may be possible for corporate members to continue to play a proportionate part in governance in the existing board. This could be achieved if, for example, the types of issues currently giving rise to conflict of interest are delegated to another level of governance, at which the conflict does not exist.

Conclusions

The Cooperative Group has changed from being an exclusively federal to a predominantly primary society. Although its governance has evolved to rebalance the competing interest of individual and corporate members, it has not so far been structurally reviewed.

Currently, the governance arrangements build in systemic conflict of interest for representatives of corporate members carrying out certain functions on the Board.

This needs to be addressed, either by limiting those corporate members whose representatives can take part in governance in the relevant areas, or by delegation of issues giving rise to conflict to a level where the conflict does not exist.

7. An Independent Secretariat

The starting point

Section 2 explained that in a corporate entity, there is typically a separation of ownership (by members or shareholders) and control (by the board). The many delegate to the few responsibility for running the corporate entity. Basic corporate law requires those in control to report back to the owners on an annual basis, giving an account of their stewardship of the corporate entity's business.

Within cooperative governance, as is explained in section 4, there is then a further separation between the democratically elected board and management, into two discreet tiers within the governance structure. This is the point at which the primary interface between the members and management takes place.

Historically, the secretary has played an important role at this point of interface. The elected representatives of the members (the board) can only do their job if they receive appropriate information about the business, and if they are supported in carrying out their role from within the business. Traditionally, the role of the secretary is to act as the servant or "clerk" of the board, keeping a record of its proceedings, sending out agendas and papers for meetings, making practical arrangements for meetings, and generally facilitating the smooth operation of the society's governance.

Although a chief executive or manager could provide that support, such an arrangement would be open to abuse if the board was completely dependent for its information about the business upon an individual who had virtually unfettered control of the business, and whose remuneration is likely to be linked to the trading results of the business.

In looking for modernised world-class governance arrangements for the Cooperative Group in the 21st century, what should the position and role of the secretary be

within the society?

It is helpful to look at the law and best governance practice in other corporate entities, and then to consider the specific issues affecting cooperatives.

Companies

Until the Companies Act 2006, all companies were required to have a secretary³⁷. Under the 2006 Act (when it comes into force), it will no longer be necessary for private companies to have a secretary, though public limited companies will have to continue to do so³⁸. It is the duty of the directors of the company to make sure that the secretary is qualified to hold the position, which essentially means that they have served for three of the last five years in such a role, or are a member of an approved institution or profession.

Neither the 2006 Companies Act nor any of its predecessors defines the role of the secretary. Typically, a company secretary is responsible for keeping the minutes, calling meetings, filing documents required by statute to be filed, and keeping the corporate seal. The secretary is specifically authorised by law to witness the seal of a company (or to sign a document under seal nowadays as a formal seal is no longer required) in the same way that directors are so authorised. However, there is nothing in the legislation to say that a secretary has to do any or all of these things.

The Combined Code on Corporate Governance sets out the requirements to be followed (on a "comply or explain" basis) by PLCs listed on the London Stock Exchange. It is in the context of the flow of information that the role of the secretary mainly appears in the Combined Code. Main Principle A.5 provides as follows:

The board should be supplied in a timely manner with information in a form and of a quality appropriate to enable it to discharge its duties. All directors should receive induction on joining the board and should regularly update and refresh their skills and knowledge.

37 Section 170 CA2006

38 Section 271 CA 2006

Under the Supporting Principles, the following appears:

Under the direction of the chairman, the company secretary's responsibilities include ensuring good information flows within the board and its committees and between senior managers and non-executive directors, as well as facilitating induction and assisting with professional development as required.

The company secretary should be responsible for advising the board through the chairman on all governance matters.

Finally, Code Provision A.5 provides as follows:

All directors should have access to the advice and services of the company secretary, who is responsible to the board for ensuring board procedures are complied with. Both the appointment and removal of the company secretary should be a matter for the board as a whole.

In other words, in a listed company, the company secretary is seen as a servant of the board and the company generally.

NHS Foundation Trusts

Although NHS Foundation Trusts are relatively new, having only come into existence as a result of the Health and Social Care (Community Health and Standards) Act 2003, it is interesting to see how the secretary issue is addressed in this new corporate entity which includes a democratic element (the board of governors).

The first point to note is that the 2003 Act makes no mention of a secretary. This is surprising – both company law and industrial and provident society law cover this in primary legislation – and it may be an oversight. This is perhaps recognised by the NHS Foundation Trust Code of Governance published by the regulator of NHS foundation trusts (Monitor)

which sets out in Appendix A the role of the foundation trust secretary, as follows, closely following the Combined Code:

The NHS foundation trust secretary has a significant role to play in the administration of corporate governance.

In particular, the trust secretary would normally be expected to:

- *Ensure good information flows within the board [of directors] and its committees, and between senior management, non-executive directors and governors;*
- *Ensure that board procedures of both the board of directors and the board of governors are complied with;*
- *Advise the board of directors and the board of governors (through the chairman) on all governance matters; and*
- *Be available to give advice and support to individual directors, particularly in relation to the induction of new directors and assistance with professional development.*

Accordingly, the NHS foundation trust should give careful consideration to the appointment of a trust secretary in view of the clear benefits of the role. A trust secretary is normally employed by the NHS foundation trust. All directors and governors would have access to the advice and services of the trust secretary. Both the appointment and removal of the trust secretary would be a matter for the chief executive and chairman jointly.

It is interesting to note that the secretary is seen as having a responsibility in relation to the democratic part of the organisation. This probably reflects the influence of the existing cooperative and mutual sector, NHS foundation trusts having been explicitly modelled on traditional cooperative and mutual societies. However, it is notable that the governors have no role in the appointment or removal.

Cooperatives

Rather like company law, industrial and provident society law requires there to be a

secretary³⁹, but without specifying any function or role.

The Corporate Governance Code of Best Practice published by Co-operatives UK includes a specific provision at paragraph B5.4, which is as follows:

The Secretary has specific responsibility to the society as a whole for its sound governance and for the guidance of the board in the discharge of its responsibilities and in particular to ensure appropriate and timely information.

The board has a right to expect the secretary to give impartial advice and to act in the interests of the society.

The secretary should ensure that directors have the opportunity to update their skills and knowledge to fulfil their role both on the main board and on board committees. The society should provide the necessary resources for developing and updating directors' knowledge and capabilities.

The secretary's main reporting line is to the board and in between board meetings his/her first point of contact is the chair.

The secretary is also responsible for ensuring that committees of the board are serviced.

Discussion

The governance context in a cooperative is significantly different from a company (or a foundation trust) in a number of respects. First, in a company (PLC) a significant number of directors will be executive directors, including the chief executive. A significant number of board members in a company (who collectively carry fiduciary responsibility for the business) are therefore already likely to be privy to information about the business. In cooperative governance by comparison, currently there is a

complete separation between the (non-executive) board and executive, in that the chief executive is not on the board and is not therefore one of the group of people sharing fiduciary responsibility as a board member.

The separation between board and executive applies in the other direction as well, in that the board has no representatives on the executive where the day to day business is being run.

The second point to note is that board members of a cooperative are democratically elected lay people, and not (as with non-executive directors in the PLC context) selected professional executives with their own independent knowledge and skills in running a business. They are therefore not only dependent on the executive for providing information about the business, but they are also likely to be dependent on the executive (to a greater or lesser extent) for interpreting that information, and being made aware of its significance.

The information link between board and executive therefore needs to be carefully addressed, to ensure that arrangements are in place to make it most likely that the board will receive all relevant information and to minimise the opportunity for abuse by the executive. Whilst normally executive relationships with the chair and other members of the board would be expected to provide other channels of communication which help to secure good governance, such informal arrangements cannot always be relied upon. Designing good governance requires making provision for where the informal relationships break down under the tension of the issues facing the business.

In any organisation which combines an elected democratic element with a professional management element, the democratic side needs to be properly and professionally supported if it is to be effective. Our research into the attitudes and experience of elected Ministers and Councillors strongly emphasises this point.

Even if the democrats have implicit trust and faith in management (which would be expected),

³⁹ Section 2 (2) Industrial and Provident Societies Act 1965

it is still necessary to have arrangements which provide them with their own person whom they regard as their independent point of contact with the society, and their own professional support. An individual who is simply beholden to the chief executive cannot, at the end of the day, give them any comfort that they are receiving all relevant information, presented in a fair and impartial way. Furthermore, should the board ever feel the need to take independent advice, a mechanism is needed to enable this to happen.

The basic premise therefore is that the secretariat needs to be independent of the executive. There are a number of elements to this.

The first is that the secretary is appointed and removed by the board (and not by the chief executive). It has to be a person in whom the members of the board have confidence and trust, and who they believe to be independent of, and of sufficient character and experience to be capable of constructively challenging the Chief Executive in their advocacy of the board, where required.

The second point concerns the secretary's role and functions within the society. Although the secretary of a large organisation is a substantial job, it is commonly combined with other executive functions which are not directly involved in front-line trading (legal matters, insurance, pensions etc.). This enables a job to be created which commands a level of remuneration likely to attract an individual of sufficient calibre for the role. It is more or less inevitable therefore that the secretary will report to the chief executive in some capacity. This can give rise to some tension, as the chief executive is entitled to determine the executive team and how it operates, and that is another potential weakness of the conventional approach to cooperative governance.

If the secretary has no executive role within the business, the risk is that the secretary is insufficiently knowledgeable about the business to be able to be the independent source of information which the board needs to monitor the business. Furthermore, there

is also the risk that the secretary carries less weight with both the board and the executive if they are merely seen as "clerk to the board" and not an insider in the business. This issue does not arise in a PLC, for two reasons. The first is because of the nature of the unitary board containing executives and non-executives, such that all board members have the same information. The second is that one of the key functions of PLC non-executive directors is to perform an independent role – independent of the executive. Also, being professionally qualified they are less exposed to the risk of being misled by a devious chief executive than lay or democratically elected cooperative directors.

If a cooperative is to be a successful business in the long-term, the relationship between board and executive has to operate smoothly through the difficult as well as the easier times, and has to be able to weather the storms of day to day business. Without an independent secretariat, in the traditional model of cooperative governance, the society runs a significant risk that the board will not have a clear and unadulterated picture of what is going on in the business, and will only become aware of issues after the event.

It follows that if a significant number of independent non-executive directors were to play a role in a new design of governance, this would be likely to have an impact on the nature of the role of the secretary, and could address some of the weaknesses of the traditional model in this respect.

There is a third aspect to the role of the secretary in cooperative governance which should be mentioned. Democratic ownership involves matters which usually have substantially less significance in investor-owned businesses. The operation of the democratic arrangements, including the election of members' representatives to the board and to other democratic structures, and the supporting and servicing of such structures and their meetings, including all of the processes and procedures involved, require the involvement of a person or persons within the

society (i.e. employees) who are regarded as sufficiently independent of management, impartial and professional. Such individuals have to work with both management and democrats to facilitate the interface at local, and regional level within the society. Without this, there is a risk that members lose confidence in the ownership structure, and become suspicious of management, to the ultimate detriment of the society and its trade.

Conclusions

The secretariat of a cooperative (within the traditional cooperative governance structure) needs to be independent of management. This requires that:

- **the secretary is appointed and removed by the board**
 - **the person appointed is of sufficient experience and calibre to stand up to the chief executive**
 - **any executive responsibilities which are combined with the role of secretary do not undermine the independence from management**
 - **elected democrats need professional support to discharge their duties.**
-

8. Members and democratic structures

Section 4 asked the question: what factors need to be taken into account in designing an appropriate governance structure appropriate for the Cooperative Group in the 21st Century? It then dealt with issues affecting that part of governance involving the board and management. This section will consider issues affecting those parts of the governance linking the membership to the board and to the society itself. It is in two parts. Part 1 looks at issues affecting the arrangements for membership, and how members participate. Part 2 looks at issues affecting the democratic structures between the members and the board.

Part 1 - Members

The main function of members is to be the owners of the society. It is ownership by the members – people who trade with the society – which distinguishes a cooperative from investor-owned businesses.

The aim of membership is not, as in a company, to derive a financial return. The aim is to support the society through playing a part as one of the owners for the time being:

- Simply being a member, trading with, supportive of and loyal to the society
- Receiving information about the society's affairs
- Attending meetings and hearing reports on the business
- Taking part in meetings, expressing views, voting in elections, or resolutions about the future of the society put to the members
- Seeking nomination for elected office within the society
- Serving in an elected office

As owners, the members are in control of their society. This manifests itself in two ways. First, any change to their society through change to the constitution, merger with another society, or decision to wind-up, has to be made by the

members. As owners, these decisions belong to them – there is no other group of people who have these rights.

Second, as owners of the society, the management of the business is under their control, through their elected representatives. Although managers are employed to run the business on a day to day basis, the membership has the power to remove and replace the management if they are not delivering the service the members require (the mechanism of accountability). In addition to this, members actively take part in setting policies and making decisions⁴⁰.

The Cooperative Group has two categories of members, Corporate and Individual Members.

Corporate Members

Membership - a "society or company or corporation" making an application for membership as a corporate member has to apply for corporate shares, and the number of shares is in proportion to the number of members of the applicant. Apart from this, there are no other eligibility criteria for Corporate Members, but the obligations of membership (purchasing from the Society such goods and services as the Society is able to provide)⁴¹ plus the requirement to apply for substantial numbers of shares effectively means that only other retail societies are likely to wish to become members. The Board has an absolute discretion to grant or refuse an application for membership⁴².

Representation – as a constituency of members, the Corporate Members currently have eight representatives on the Board, elected via corporate elections⁴³. Voting strength in elections is determined by purchases⁴⁴.

Attending meetings – Corporate Members attend General Meetings of the Society via

40 ICA Statement of Cooperative Identity – 2nd Principle: Democratic Member Control

41 Rule 15

42 Rule 7

43 Rule 117

44 Rule 102

delegates, and the number of delegates they are permitted to send is based on their purchases from the Society⁴⁵. On any vote at a General Meeting which is either a card vote or a referendum, the number of votes for each Corporate Member is based upon purchases. “Purchases” for the purposes of determining both the number of delegates and voting strength at meetings are determined by provisions contained in the rules⁴⁶.

Individual members

Membership – there are no eligibility criteria for Individual Members, though the Board has an absolute discretion to grant or refuse membership. The UK is divided into 9 geographical regions (including the United Region) which are themselves divided into 45 Areas (and 4 United sub-regions). Each Individual Member appears on the register of members for the Area in which they reside.

Representation – Individual Members may be elected (by individual members) onto Area Committees, subject to qualification criteria. Having served on an Area Committee for 24 months, an Individual Member may then be elected onto a Regional Board. Different electoral processes apply in different Regions, but broadly every Area has a seat on a Regional Board, and it is the Area Committees, or Area Committee members who elect the Regional Boards. In the United Region, there are Regional Councils rather than Area Committees, and also Member Relations Committees.

The United Region currently has eight representatives on the Board; the other eight Regions have seventeen directors between them, ranging from one to three per Region. Regional Board members are nominated by Area Committees to the Board, and they are then elected (in regional rather than national elections) by Area Committee members individually from within their Region.

Attending meetings – Individual Members have the right to attend a Members Meeting in their Region, which normally takes place before the Society’s AGM, and a Members Meeting in

45 Rule 82

46 Rules 86 and 87

their Area, which normally takes place prior to the Half Yearly Meeting. The purpose of these Members Meetings is to receive a report from the Regional Board or Area Committee (as appropriate), and to enable Individual Members to raise issues to be considered by the Society’s constitutional bodies.

Individual Members do not have a right to attend the Society’s General Meetings. Instead, they are represented at General Meetings of the Society via delegates from their Region, who must be members of the Regional Board, or of an Area Committee (Regional Council in the United Region). The number of delegates which a Region is entitled to send to General Meetings, and the voting strength at such meetings is based upon purchases by the Region from the Society. There is no direct link between Members Meetings in Regions and Areas, and General Meetings.

Issues arising

Corporate members

Membership – whilst the number of corporate members has been in decline for many years and is likely to continue to decline, no specific issues are raised at this stage in connection with the membership of Corporate Members.

Representation – as the number and comparative economic size of the Corporate Members changes in relation to the Cooperative Group’s own trade as a primary society, so it is likely to be necessary to continue to adjust the balance of representation between Corporate Members and Individual Members. A new “settlement” is required following the transfer of engagements by United. Previously there were seventeen Regional Directors, and eleven Corporate Directors. It seems appropriate that there should be some relationship between the proportion of directors appointed by Corporate Members and Individual Members and trade.

A further issue which has arisen in connection with the representation of Corporate Members is conflict of interest. This issue is set out more fully in section 6, which recognises that because

the Cooperative Group has changed to being a predominantly primary trading society, conflict of interest is more likely to arise within a representative structure which is still partly federal. This is an issue which needs to be resolved at Board level for the future.

Attending meetings – no specific issues are raised at this stage.

Individual members

Membership – there are two issues to consider.

1. Number of regions – prior to United transferring engagements, there were eight Regions, and forty-five Areas. Temporarily, there is an additional United Region (which geographically overlaps existing Regions), and the United Region is itself divided into four sub-regions.

Clearly, the Regions need to be reorganised to remove the overlap. Staying with the existing Regions and incorporating the United members and trade into the existing regional structure will clearly have an impact. The basic questions to consider are:

- Should the number of Regions and Areas stay the same, or should there be an increase or reduction in number?
- Should the boundaries of existing Regions and Areas be varied on some basis, e.g. to bear more relation to volumes of trade, or numbers of members?

As a cooperative society providing services throughout the UK, appropriate arrangements are needed to ensure that there is a real sense of ownership of the society by its members and democratic control by members. A number of factors have to be balanced in deciding what arrangements would be appropriate, and in answering the questions above, of which the following are some of the more important ones:

- The ability of Individual Member to participate effectively in the Society's affairs (affected amongst other things by the size of the Region, geography,

transport and road systems, local culture and politics)

- The effective use of the Society's human and financial resource in servicing the membership, so that the ownership and membership structures are proportionate to the needs of the business.

The previous Constitutional Review which commenced in 2006 and resulted in a consultation summary document dated 3rd November 2006 which sets out the work done and thinking to date. This document broadly concludes that there was little current appetite for any significant change to the Regional structure, and the number of Regions and Area Committees.

It seems likely that incorporating the United Region is an issue to resolve politically, but there is no objective reason to argue that this should not result in a radical alteration to the number of Regions or Areas, or their boundaries.

2. Employee constituency – currently, there is no distinction between members on any ground other than geography (i.e. members are registered by Area in relation to where they live). In particular, although members comprise both customers and employees, there is no separation into constituencies.

The role of employees in consumer cooperatives has been the subject of controversy for more than a century. The situation today is that many employees are active as members within the Cooperative Group and other consumer societies; that employees play a vital role in promoting the cooperative proposition in the market-place; and that a number of leading societies (including the Cooperative Group) over recent years have explicitly recognised employees as well as customers in their distribution strategy.

The Report of the Cooperative Commission recommended in 2001 that societies should encourage employees to become members of the Cooperative Movement themselves, and

to participate actively in the Society's internal democracy via a "reserved employee constituency". The report acknowledged that those who object to employee representation argue that employees should seek election to office as members of the Society and should not represent the employees directly, but rather should have the long-term interests of the Society at heart. The counter argument is that if employees are to be encouraged to be stakeholders in the business then they need their own electoral arrangements in relation to representation within the Society.

The reality is that employees are already recognised within the rules of the Cooperative Group, because there is a restriction (of 1/3) on the number of employees who can hold office on Area Committees, Regional Boards and the Board. Although the objection above to employee representation is a valid one, exactly the same point arises in relation to any elected representative: a Board member from a particular Region should not represent their Region directly, but should have the interests of the Society as a whole at heart. There is a continual need to educate and remind elected representatives of this.

The counter argument is also not particularly strong – it is difficult to say that employees need their own electoral arrangements if they are to be encouraged to be stakeholders.

Perhaps more obvious points are that the current arrangements are not particularly transparent; but that creating separate constituencies reduces the number of candidates that each Individual Member elects. It is increasingly common in other large mutual organisations to recognise staff as a separate constituency (e.g. foundation trusts⁴⁷). Part of the reason for this is to ensure staff representation, but prevent staff control, which is equally important in a consumer cooperative.

The point really is to decide how employees can be assisted to feel part of, and play an appropriate role in the co-operative endeavour.

The academic evidence and case study work suggest that employee ownership and/or financial participation through Employee Share Ownership Plans (ESOPs) tend to be associated with enhanced business performance, although evidence on this point is mixed.

The research literature does suggest that employee engagement can enhance the performance of businesses and other organisations. Many firms have thus sought to create such engagement through the use of various Human Resource Management practices, including financial incentives through employee share ownership schemes and stock options.

The evidence suggests that two factors need to be present to ensure the success of such policies. First, the policies need to be pursued in a coherent manner; one policy by itself may fail to have an impact if it is undermined by other management behaviours and practice that fail to support – or even undermine – that one initiative. And secondly, there must be a degree of belief amongst the employees that the policies being introduced or implemented are genuine, and not just a fad or even a trick, and that they will be pursued consistently and not just abandoned at some point in the future.

How this belief amongst the workforce can be generated and sustained is then a further important question in its own right. It certainly requires the managers themselves to believe in the policies. It also requires a degree of assurance that management will be permitted to pursue the policies over the long term and will not be subject to outside pressure for example from shareholders to abandon the policies to cut costs or for some other reason.

It may therefore be that such benefits might be achieved through routes other than the providing an express constitutional constituency for employees. A mechanism needs to exist that rewards and engages employees as members, whether through ESOPs or by providing enhanced profit share. Such a commitment may need to be written into

employment contracts to achieve the level of trust research suggests is required.

This issue should be considered afresh by the Review Board, who should not be hide-bound by the historical debate.

Representation – there are two issues to consider here.

The first concerns the current electoral arrangements whereby Regional Board and Board members are elected by the Area Committee members within their Region. This means that individual members have no direct say in who represents them at Regional Board or Board level. This is consistent with the delegate system for attending General Meetings. The advantage of the arrangement is that an individual's vote may have more influence than in a large national election, and the electorate is more likely to know the candidates they are choosing from, making it a more meaningful election. The alternative is direct elections to the Regional Board and Board by members. An important factor to bear in mind is that the current electoral system is part of the predator protection arrangements, because they prevent direct access to the Board by an individual member.

However this arrangement runs the risk that it may lead Regional Board and Board members to make decisions based on the narrow interests of their Region or Area, rather than in the best interests of the Society. Whilst their legal responsibilities can be continually emphasised, the likelihood of re-election is a powerful factor influencing how individuals behave.

The counter argument to national elections is that they favour electoral organisations who are able to operate at national state. This can result in candidates winning with little support in their own geographical regions. One upside to national voting is that it is then possible to operate quotas to balance under-represented groups.

The second and related point concerns the role of Regional Boards in approving certain acquisitions and closures. Inevitably, an acquisition will increase a Region's trade and a

closure will decrease it; where voting strength is based upon purchases, the risk is that the consequential effect upon voting strength may have an effect upon decision-making. If this risk is considered to be significant, then there may be an argument for detaching voting strength from purchases, as between the Regions.

Attending meetings

As already pointed out, Individual Members have the right to attend Members Meetings in their Region and Area, but no right to attend the Society's General Meetings which are delegate meetings. Furthermore, there is no direct link between the Members Meetings and General Meetings. The issue is about making the meeting process open to members, either through attendance or the use of other technology / media.

There is a stark contrast here for those former members of United, who are now Individual Members of the Cooperative. They have been used to attending and voting at members meetings, and currently they cannot do so.

The General Meetings of the Cooperative Group are delegate meetings because historically the Cooperative Group was a federal society owned by its Corporate Members. As already pointed out, it is now a predominantly primary society.

The question should therefore be asked: should the current delegate meeting continue, or should this be changed to a more conventional meeting open to any Individual Member?

The following are some of the more obvious factors for and against changing.

For

- Individual Members have no direct say in (i.e. no ability to approve or block)
 - o changes to the constitution of their Society
 - o transfer of engagements or conversion
 - o other strategic issues referred to General Meetings
 - o the distribution of surplus recommended by the Board
- Individual Members have no opportunity

to hold management and elected representatives to account on their custodianship of the society and its business

- Members of the former United Society are used to it and likely to be in favour of it
- It may be a factor affecting a decision by the members of any potential incoming society
- The general tenor of the society is set by the pro-active type of people who want to get involved, but who are not necessarily representative of the general character of the Individual Membership
- The point of Individual Membership and the reality of ownership by the Society's Members seem to be diminished
- Although one General Meeting for the whole Society would be unlikely to be practical because of the distance Individual Members would have to travel, the use of modern technology, and multiple meetings (as employed by other large societies) provide other options
- Member delegates could be appointed from members meetings

Against

- The current arrangements work reasonably well, even though they were designed for a federal organisation
- Members Meetings in the Regions and Areas provide sufficient opportunity for Individual Members to have direct interface with executives and elected representatives
- The current arrangements are an important part of the Society's predator protection provisions
- Changing to meetings open to Individual Members
 - o would be unduly costly and burdensome for the Society
 - o would require appropriate arrangements to be introduced for Corporate Members
- Other less radical measures could be considered if there is a strong sense that Individual Members are insufficiently

enfranchised by the current arrangements, such as

- o The use of postal voting by members to ratify certain decisions
- o Video conference viewing facilities for Individual Members for General meetings

We should not lose sight of the geography and scale of the Group in this debate. Any practices need to be scalable and new technology will be key to this. The issue is how members can meaningfully influence the Society rather than just attending meetings. This should be explored further.

Part 1 – Conclusions

A new settlement is needed concerning the number of directors representing the Regions, and the number representing Corporate Members.

The United Region needs to be incorporated into the Cooperative Group's regional structure, and other than a need to strike an appropriate political settlement, there is no fundamental reason to adopt a radically different regional structure in terms of number of Regions and Areas, or boundaries.

Consideration should be given to whether there should be a reserved membership constituency for employees or whether their engagement should be secured through other contractual means

Consideration should be given to whether Regional Board and Board members should be directly elected by the members, and whether elections to the Board should be national rather than regional elections.

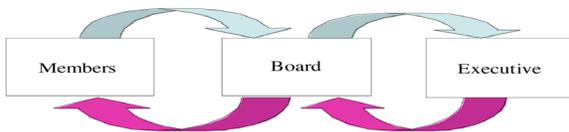
Consideration should be given to whether the current federal General Meetings should be replaced by meetings open to Individual Members, or whether other measures should be explored.

Part 2 – Democratic Structures

One of the conclusions of section 3 was that being a cooperative business means being owned and democratically controlled by members. Part 1 of this Section looked at issues affecting the arrangements for membership, and how members participate in their society. This Part will look at issues affecting the democratic structures between the Members and the Board.

The function of democratic structures

A small cooperative society serving a limited community can rely upon a basic structure whereby members simply elect their representatives. Members retain ownership and control of their society by means of the closeness of link between themselves and their elected representatives. Or to put it another way, the elected representatives can provide an effective link between members, and those employed to provide the service to them.



An effective link is important to enable the members to inform the business of their ongoing and changing needs, and to enable the business to communicate to members the issues it is facing in providing the service. An effective link is also necessary to ensure that those running the business remain accountable to the owners – so that they are encouraged when the business is doing well, constructively criticised when they need to adjust their approach, and replaced when they are failing to deliver.

The role of the elected representatives of members in a cooperative structure is to provide the link, in both directions, between members and those running the business; the link has to serve the purposes of communication, so that the business remains responsive to their needs, and accountability, so that the members retain

their ownership and control. “Control” does not just mean having the ability to hire and fire the managers. The 2nd Cooperative Principle makes it clear that members participate in setting their society’s policies and making decisions. Members mainly do this through their elected representatives.

For a business as large and complex as the Cooperative Group, the elected Board cannot realistically act as an effective link between those running the business and the members. Intermediate structures are needed, so that the links can be effective, both at ensuring that the essential two-way communication between members and managers takes place, and to make sure that the chain of accountability operates effectively.



The intermediate structures can also provide a mechanism whereby members, in a large society, participate (at more than just the top level) in setting their society’s policies and making decisions. In a modern business environment, members’ participation in the business of the society has to be approached pragmatically. There is no point in employing experienced professionals, at market-rate salaries, to run the business and make difficult decisions if in exercising their professional judgement, they are going to be over-ruled by others who do not share their competence. Furthermore, given the competitive market-place and the need to achieve economies of scale, the business’s ability to operate efficiently and effectively overall will be impaired if decisions taken centrally are open to local variation.

There is a balance to be struck. As a cooperative business, the society must, as a matter of law, remain owned and controlled by its members. The communication and

accountability links are a priority in this regard, and must be designed to be as effective as possible to achieve their objectives. But if members are to remain interested and engaged, and participate as required, there is a point at which they need to interface with the managers of the business and have an impact on decision-making; and not just at top tier level. However, the society exists in order to trade as a business. It is therefore important that at each level, the arrangements are appropriate for and support the business, rather than impede it.

An international perspective

A cursory examination of other large scale international mutuals can certainly lead us to question whether 'stretching the accountability chain' is effective either in terms of engaging with members or running a successful business. Of the five comparative international co-operatives examined, only Rabobank and Desjardins have three tier structures, with shorter chains of accountability in each of the other three cases.

Whilst Desjardins nominally has a three tier structure, in that local, regional and central structures all exist; in practice recent reform has led the co-operatives to take decision making powers out of the hands of regional bodies. Before this restructuring, the relative powers and roles of the regional and central boards had been relatively undefined, which led to conflict between them. Each region was politically led, and would fight its battles on the central Board of Directors. The confusion that this led to is described below:

'The Federation would issue a policy on something. The regional federation would take it, put its own logo on it, and design it a bit differently...By the time it got to the caisse, they would have piles of papers, some coming from the confederation, and some coming from the regional federations...We had over 200 bodies taking decisions, which meant that there were too many meetings, too many people making decisions and too many decisions being made.'

By contrast, while Rabobank's three tier

governance structure allows for decision making to be taken at every level of the organisation, one can certainly argue that it provides a weak chain of accountability for its members. Whilst it does still allow open elections to its Members' Councils, their powers are relatively weak. They are unable to nominate their representatives to their local Supervisory Board, with other authorities mainly limited to formal powers of veto over constitutional decisions; which are rarely used in the lifetime of any organisation.

If one is to look to engagement with members, perhaps the most successful international example is S-Group, whose 1.7 million members include 65% of the households in Finland. It is a two tier co-operative whose regional supervisory boards are directly elected by the membership. These elections tend to be heavily contested and hard fought, with average turnouts of approximately 40%, which can be as high as 60-70% in some regions.

Area Committees and Regional Boards

The Rules of the Society say little about their roles and responsibilities. The rule provisions only deal with their rights in relation to participation at General Meetings and certain other meetings, becoming a member of any cooperative or other organisation, and nominating individuals for election⁴⁸.

The Board, however, has the power both to delegate powers and duties (subject to certain restrictions) to Regional Boards⁴⁹, as well as the power to approve Regulations for Regional Boards and Areas⁵⁰. Under these arrangements, the roles and responsibilities of Regional Boards and Areas are set out in Appendices 6 and 7 of the Regional Regulations.

Roles and responsibilities of Regional Boards

These are set out under two headings, Commercial, and Constitutional and membership. The first heading includes the following:

48 Rules 23 and 24
49 Rule 145 (g)
50 Rule 21 (a)

- Reviewing management proposals in respect of the regional revenue and capital expenditure budgets and making recommendations to the Board
- Receiving and monitoring sales and profitability of the Region against budget and previous year to ensure improved performance and growth
- Receiving and monitoring performance of the Region against KPIs
- Making recommendations in respect of the development of the Region
- Considering capital expenditure proposals for the Region, authorising those between £50,000 and £3m, noting those below that limit, and reviewing those above and making recommendations to the Board
- Approving proposals for the closure and disposal of core trading units in the Region

Under the Constitutional and membership heading, the following are included:

- Appointing and mandating delegations, submitting motions, putting questions to and casting the Region's vote at General Meetings and other meetings
- Laying before Members meetings in the Region reports detailing the trading and financial performance
- Considering the wishes of Members as expressed via resolutions at meetings
- Overseeing the work of the Regional Values and Principles Committee
- Engaging with local and regional government on Society interests and Cooperative values and principles

It can be seen from this (and the full list of roles and responsibilities) that Regional Boards have a significant ability to impact on the business. The power to approve (or not) some capital expenditure items, and some proposals for closure and disposal, gives the Regional Board an actual participation in decision-making. The reviewing of significant trading information and the ability to feed their views and recommendations back to the board also ensures that they are playing an important part in the link to the Board and management.

According to the November 2006 Consultation document, the Regional Boards receive visits from the Group Chair, Group Chief Executive, members of the Executive and senior management, and regular mailings on matters discussed by the Board. There are twice yearly meetings of the Regional Chairs with the Chief Executive, Group Secretary and Board. Together these measures have improved communications, according to the Consultation document, which expresses the view that the eight Regional Boards operate in a fairly consistent manner, and that there appears to be a good understanding of the role of both elected members and management. It is an obvious point that the transfer of engagements by United has taken place since these views were expressed, resulting in significant changes in management and dynamics. These changes clearly need time to settle down.

Roles and responsibilities of Area Committees

These are also set out under the same two headings. Under the Commercial heading, the following are included:

- Receiving reports on trading performance in the Area, and bringing to trading management's attention anything relating to the conduct of the business which appears to require attention
- Making recommendations to management and the Regional Board about development of the business in the Area
- Being consulted on intended store closures, disposals, and new developments
- Conducting visits to Society trading premises

Under the Constitutional and membership heading, the following are included:

- Nominating, appointing and electing to various bodies including the Regional Board
- Planning and delivering a range of events and activities in the Area
- Planning the allocation of the membership budget for

appropriate membership and community programmes

- Developing and monitoring the activities of informal local Members groups
- Allocating the Community Dividend, and working with local employees on community initiatives
- To engage with the wider movement in their Area

It can be seen that the Area Committees have no decision-making role in relation to the business. They receive limited trading information, but unlike the Regional Boards, there is no monitoring role. All they are expected to do is make sure that local management is aware of anything which requires attention.

Although Area Committees are the tier closest to Individual Members, there is limited mention of their role in relation to Members. Particularly under the second heading, it is more a list of tasks than of roles.

The November 2006 Consultation Document identified a number of issues in relation to Area Committees, including the following:

- Variation in the interpretation of the role, rooted in Regional traditions
- Some focussing significantly on membership and community issues, others primarily interested in scrutinising trading
- Confusion in the role of Area Committees and Regional Boards, some looking to delegate powers to Area level
- Management concern about the confidentiality of sensitive trading information going down to Area Committee level
- Doubt about whether Area Committee members were expected to show cabinet responsibility, or were free to speak out
- A failure of communication between Area Committees and Regional Board

Further research was commissioned from an external provider, and a number of important conclusions were reached. In relation to Individual Members who were not elected onto Area Committees, the summary was as follows:

- They wanted Area Committees to be “the voice of the customer” and be primarily focussed on ensuring that the in store experience is as positive as possible for customers
- Area Committees should be responsible for monitoring in store experience even if the Cooperative Group already has tools in place to monitor this
- They see a role for Area Committees to form a link with their local community, deciding where Community Dividend should be allocated, and educating customers about the Cooperative and its values
- Recruiting members, organising events, feeding back local product needs and store profitability and trading performance were not spontaneously mentioned, and seen as secondary responsibilities

Area Committee members felt there was too much to cover in their meetings, and almost a third did not have a clear idea of what their roles and responsibilities are. They would welcome clarification of this, and ideally wanted to be focussed on ensuring that in store experience is as positive as possible.

In other words, both Area Committee members and unelected Individual Members were focussed on the business and wanting to help it to be better, in Area Committee members case through making recommendations on how stores could be improved, and listening to members needs and conveying them to management. Both sets of consultees were shown an ideal roles and responsibilities model, and all unelected Members and a vast majority of Area Committee members felt that it encompassed their requirements. It was as follows.

Ideal Roles and Responsibilities Model

- The Cooperative Group is first and foremost there to serve its members, and therefore the focus of roles and responsibilities of Area Committee members needs to be on serving local communities and making the shopping

experience better. With this in mind, the balance of roles and responsibilities should be:

Primary area of focus – the most important roles and responsibilities of Area Committees

- o Ensuring the in store experience is as positive as possible by listening to and identifying the needs of customers in the area, monitoring store standards in the area and making suggestions as to how they could be improved
- o Educating customers in the Area about the Cooperative movement, what it stands for, its Values and Principles, etc.
- o Deciding which local charities/groups Community Dividend should be given to

Other areas of focus – where Committee spends some time discussing and helps to support other groups/individuals within the Cooperative Group

- o Providing local knowledge on issues that may impact stores in the Area
- o Being consulted on whether stores in the Area should be closed

Secondary areas of focus – committee spends some time discussing from time to time, but is not the main focus of Area Committees

- o Studying trading performance and highlighting stores that are not trading as well as they should be
- o Being responsible for organising events/activities for members in the Area

Finally, before making comments on the existing arrangements, it should be pointed out that the intermediate structures for the United Region have historically been different. United had four Regional Councils, who were focussed on the business rather than membership issues. There

are separate Member Relations Committees, whose functions are clearly set out in the former rules of United. These are focussed on developing members and their participation in the society, and included in particular “encouraging the highest level of member participation within the Society’s trading and democratic activities and structure”.

Some issues arising

A clear decision is required to establish the optimum number of formal governance tiers.

Regional Boards – currently there seems to be limited justification for significant change to the roles and responsibilities of Regional Boards. They have been in place for a relatively short time in their current format (since 2001), and have not drawn serious criticism. The roles and responsibilities do not seem to be inappropriate, when looked at against the requirement for them to play a part in the linking mechanism between members and management described in Part 1, save in one respect.

The external research commissioned after the November 2006 Consultation Document did draw out that a fairly high proportion of elected Area Committee members feel that they are not currently able to make a difference for the benefit of their local communities or shoppers. This raises a question about the links between Regional Boards and Area Committees, and the extent to which the chain of communication between members and managers is recognised by them, and the part they play in it is appreciated. Without any direct power in relation to the business, Area Committees rely upon making recommendations to Regional Boards to have any business impact, so this may be an area for further discussion and maybe emphasis.

Area Committees and Member relations Committees

– the current lack of clarity about their roles and responsibilities should be addressed. Given that they do not have any direct role in running the business, although receiving headline information would seem to be relevant, it seems inappropriate that their role

should involve any detailed scrutiny of trading results for the following reasons:

- Both management and Regional Boards have a responsibility and a greater reason to do this; it is merely duplication for Area Committees to do so as well
- Without training and support, it is difficult for Area Committees to make a useful contribution or add any significant value in this area
- There are concerns about confidentiality of information, and collective responsibility amongst so many Area Committee members
- There is a feeling that they have too much to do
- Their time would be better spend adding value in other ways

It is interesting to see the greater emphasis in the United Rules in the role of Member Relations Committee's responsibility for encouraging the highest level of member participation. Area Committee members are the people within the Society who are closest to customers and Individual Members, and arguably their greatest value to the business is through that relationship. To have wider appeal to different age-groups, it may be appropriate for them to be **less formally** structured than at present. They are effectively the eyes and ears of the Society within the community, and consideration should be given to making better use of the opportunity created by them.

Part 2 – Conclusions

The role of the elected representatives of members is to provide the link, in both directions, between members and those running the business; the link has to serve the purposes of communication, and accountability, so that the members retain their ownership and control.

“Control” does not just mean having the ability to hire and fire the managers. The 2nd Cooperative Principle makes it clear that members participate in setting their society's policies and making decisions.

There are points at which members representatives are able to have a direct impact on some decision-making.

The structures between Individual Members and the Board should be designed to meet these needs.

There should be a clear decision on the most appropriate number of tiers in the governance structure.

The roles and responsibilities of Area Committees could be clarified, with more emphasis on them being the voice of the customer. This might be better achieved if they were less of a formal tier.

9. Designing new governance arrangements – Being 21st Century Pioneers

Introduction

Designing new governance arrangements happens most frequently in relation to new organisations. Thereafter, organisations generally evolve gradually, adapting and revising their constitution and governance to meet the changing needs of their business.

Sometimes, particularly in organisations which evolve over many decades, there can be so much gradual evolution, each adaptation adding a layer onto the previous one, that when you take a step back, the original structure can start to look rather convoluted or distorted. Indeed it may even have become an impediment to the organisation. At that stage, it is important to consider whether the existing constitutional arrangements (which everyone is invariably attached to because they are familiar and comfortable) are continuing to serve the original purpose. Indeed, one even has to ask whether the underlying organisation and its original purpose or reason for existence have themselves changed. The exercise then becomes a bit like starting all over again, as if it was a new organisation looking for an appropriate governance structure.

Previous sections have pointed out that the Cooperative Group has evolved over many decades, that its original purpose and reason for existence have changed substantially, and that it has reached the point where there are some serious anomalies in the existing governance arrangements, which are arguably impeding the achievement of objectives.

It may therefore be helpful to consider the principles that would be followed in designing a constitution for a new organisation, and that is the purpose of this section. It is occasionally important not just to undertake the usual comfortable approach, just tweaking the current arrangements here and there where they need some attention.

In the light of what is said in other sections, it is necessary to consider afresh what the organisation needs for the future if it is to continue serving members for another 150 years. It is necessary to be as clear-headed and radical as the original Co-operative Pioneers: we have to be prepared to be 21st Century Pioneers.

The process of designing a new constitution

It is easiest to illustrate the process by reference to a real example which will follow below. However the outline of the process will be described first.

When a person or a group of people want to set up a new organisation or business, the starting point is usually some kind of vision – an idea which they can envisage in their minds, and which they want to turn into a reality. There is usually some kind of a need or demand for something, and they can see a way of addressing it. But before they can start, they need to be clear about why they want to do anything. That is because ultimately the organisation is only going to succeed if there is a motivation to drive it forwards. Next they have to be clear about who is going to drive it forwards – who shares the vision and the motivation to make it happen. Finally, they have to work out how it is going to happen and become a reality – where is the money going to come from, both to get it started, and to keep it going.

So the process is one of moving from vision, to business plan, and the process of working out the governance involves the following.

- 1. Corporate purpose.** The vision needs to explain what the organisation exists for, what is its underlying purpose. Is it to meet a charitable objectives (e.g. alleviating poverty), or to make a return for investors, or something else? This is not to be confused with what it is going to do i.e. what trade it is to carry out – that is the mechanism by which it is going to achieve its underlying purpose, and that comes later. At this stage we are concerned with the **corporate purpose** – why do anything at all?

2. Owners. A decision has to be made about who the owners are. Every corporate entity has owners (or members), and if it is to be an effective entity, the owners have to be people who are going to drive the organisation to achieve its corporate purpose. In a company based on the profit-motive, the owners are investors, who drive the business to deliver its corporate purpose – namely to generate a return on their investment. There may be a number of “stakeholders” or groups of people who play an important part in the business, such as employees, suppliers, or statutory bodies. It has to be decided whether or not they are appropriate to be identified as owners within the corporate entity, to have some other fixed role in the governance framework, or to have no formal role at all. This is important if the organisation is to achieve its intended purpose in the long term.

3. Business plan. The organisation is being created to provide a framework to hold some kind of business. It is necessary to write down how that business is to operate: what its capital and expenditure needs are, how it derives income, how it will be funded, what its expenses are, what the risks for the business are, and how they are to be minimised.

It is only when these areas are clarified that appropriate governance arrangements can be devised. The governance arrangements are simply the means to an end – namely achieving the corporate purpose and delivering the business plan. They are not an end in themselves.

An illustration – Salford Community Leisure

Salford Community Leisure Limited used to be the leisure services department of Salford City Council. As such, it was languishing as one service amongst a number, competing for funding, rarely the top priority, but with potentially a big role to play in the health and well-being of the local community. There was a high capital expenditure requirement to secure the assets the service needed, and under Council ownership, the service was deficit funded, i.e. viewed as part of the costs of running the Council’s services.

The decision was taken to transfer the service

into separate ownership. How were the governance arrangements designed?

First a decision was made about the corporate purpose and the type of organisation which was wanted. The vision was for a provider of leisure services to the local community, owned and controlled by the community and meeting the needs of the community. The corporate purpose was therefore to trade for the benefit of the community. It was primarily a **trading organisation** – that is to say a business, whose income had to exceed expenditure on a continuing basis, and it therefore had to be efficient, commercial and profitable if it was to survive – but its reason for existence was to serve the community, not to make a return for investor-owners.

The next question was who the owners of the organisation were to be. Since it was not being set up as a company designed to produce a return for shareholders, there would be no investor-owners. The plan was for it to be owned and controlled by the local community – the people who would be using its services, and “trading” with it; namely, the people who had an interest in making it successful so that it provided good local services. Such people included local residents, users of the facilities (both individual users, and clubs or societies which whose members used the facilities), and staff working to provide and manage the services.

Importantly, it was decided that the Council, which obviously had a major interest in the organisation succeeding and was therefore an important “stakeholder”, would not be one of the owners or members. There were other stakeholders as well: in addition to the clubs and societies using the services, a number of other statutory and commercial bodies had an interest in what the organisation was to do:

- the NHS – because of the part that sport and leisure can play in promoting healthy living;
- education – through the use of facilities by local schools and other educational benefits deriving from sport;

- community safety – through the contribution that can be made to reducing crime by sport and leisure; and
- local businesses, with an interest both in local services to improve the health and well-being of employees and the development of potential future employees.

The essence of the business plan was to move from being simply a cost in the books of the Council, to being a service provider, providing high quality services on a commercial basis. This meant transferring the leisure services undertaking to the new body; the Council granting leases of the premises; and establishing long-term service contracts between the new body and the Council, with a well-developed service specification and measurable outputs, and tight performance targets to secure value for money. It was also important to develop other sources of income for the new body, and for it to become commercially-minded and customer-focussed to ensure the success of the business. This involved a major cultural change.

The Governance of Salford Community Leisure

The corporate purpose determined that the legal form of a community benefit society (an industrial and provident society) would be used. However, the desire for community ownership and control meant that a form of cooperative ownership and democracy was needed.

Two constituencies of members were established – community members, to include users of the service or anyone living locally with an interest (e.g. parents or carers of people using the services); and employee members. Aside from local residents, there are some 42,000 registered users of the service, and 460 employees from whom the membership can be drawn. Membership is open to anyone in those categories who applies for a £1 share. Members are entitled to attend meetings, speak and vote, and elect representatives to the board. Each member has one vote.

There is a board which determines strategy, and

appoints and oversees the executive in delivering the strategy. The board of sixteen comprises four members elected by users; three members elected by staff; three individuals appointed by Community Committees (part of the local authority's democratic structures, who are themselves elected representatives of local people); two people appointed by Salford City Council; and four people appointed to represent the following interests: health, education, community safety, local business. The board is therefore made up of ten people representative of users, staff and local community, and six representing stakeholders. It has the power to co-opt a maximum of two further board members to fill any skills or experience gaps.

The business is managed by a chief executive, who is not a member of the board, but attends and reports to each board meeting.

The end result is a democratically controlled organisation, accountable to its members (users, staff and residents), which works in close partnership with the local authority, and with health, education, community and local businesses through their representation on the Board. The development of membership enables local residents to become actively involved and help to improve the services provided. Through its engagement with its local community, the promotion of fitness and healthy living, and its activities including sport development programmes, SCL is able to play an increasing role in the health and well-being of its local community.

SCL is the operator of fifteen leisure facilities including sports centres, swimming pools and fitness centres. It puts on events such as the 2007 World Cup Triathlon. It also supplies management services to Salford Sports Village. In the last financial year, it had turn-over of £8.5 million, 44% of which was generated through purchase of services by Salford City Council, 43% was turnstile revenue, and 13% grants. It is funded by accumulated reserves, and has no substantial members' capital. Trading surpluses are retained to develop the services and reduce costs.

How does this illustration assist in the search for world-class governance arrangements for the Cooperative Group in the twenty-first century?

Cooperative purpose, vision and business plan – the history

Previous sections and work have looked at the issues around corporate purpose, vision and business plan issues. The history can be (somewhat crudely) summarised as follows.

- The original purpose of cooperatives was to enable people to have access, where they would not otherwise have it, to basic provisions at a fair price and acceptable quality. It was a self-help mechanism, driven by the motivation of need.
- The vision was to have organisations trading as businesses, but challenging conventional businesses which were not meeting people’s needs, by trading cooperatively.
- The essence of the business plan was to provide everyday goods and services, at a fair price and quality, to build up trade through developing membership and loyalty, to rebate to customers through the dividend any surplus not needed for the continuing business, and to provide such other member benefits as the members decided.
- The traditional cooperative model worked well, because it was clear what customers/members wanted, management were therefore clear about what they were to deliver, and there was an alignment of the interests and democratic power of members to drive the organisation to be successful. It was thereby able to be economically successful.
- However, the traditional model no longer works in the twenty-first century.
 - o The social conditions to which cooperation was a response do not prevail today. Increased competition in the high street, consumer protection legislation,

- o and personal mobility through transport have together created a different context.
- o Consequently, the original purpose of cooperatives has substantially fallen away; the reasons for having members and democratic control have become unclear.
- o It is no longer obvious what members want today, and consequently managers are unclear about what they are supposed to deliver. The cooperative model no longer adds any value to the business, and can become resented by management, who just want to get on and battle it out in the market-place with their competitors.
- o The result is a “disconnect” between managers and members. This can result in a management mentality of: leave us to run the business (just like our investor-owned competitors), and you can decide what to do with the profits. However, this leaves the business without any clear distinction from its investor-owned competitors, and having to compete with them on their terms. Cooperative Group trading is reduced to doing something different with the profits. Even that is now lost, because most large customer-facing businesses are doing (apparently) philanthropic things with their profits.

Cooperative purpose, vision and business plan – the present context

Whilst the historical vision and purpose may have been overtaken, there is one thing today which remains as clear as 150 years ago: the need, and increasing demand for an alternative to conventional, investor-owned businesses. This can be summarised as follows.

- There is growing public cynicism about the commitment of large investor-owned corporations to serve the interests of its customers. It is widely understood that they exist to make a return for their investors, and that customers are just the means to that end. Consequently the interests of customers are not a priority, save to achieve the ends.
- The same applies to employees, who are merely an expense of the business, to suppliers, who are simply the providers of the ingredients or raw materials which the business needs to trade, and the local community, who bears the consequence of the trade in terms of carbon emissions, waste, consumption and environmental impact. All of these interests are subordinated, in an investor-owned business, to the interests of investor shareholders.
- Many people do not like this, or actively resent it. There is a growing public thirst for something different, some credible alternative.

The cooperative approach undoubtedly provides an alternative. It is important to crystallise the issues in this way, because at the point of undertaking this constitutional review, the Cooperative Group is at a watershed, both from a trading and management point of view, and from a members'/owners point of view.

From the point of view of the trade, through the recent and continuing consolidation within the sector, the society is putting itself in the most effective position to challenge the investor-owned competitors. However, once it has achieved its economies of scale through consolidation, what is the strategy then? How will it compete with larger businesses which have access to the capital markets?

A clear strategic option is to use the cooperative nature as the feature which distinguishes the Cooperative Group from its competitors. This means challenging conventional businesses by both offering to customers at least equivalent value in terms of quality and price,

but also seeking their support and loyalty of customers **because it is a cooperative and because of what the business stands for**. Effectively, this is to choose the ground on which to compete, and to make that ground the values and principles, where investor-owned businesses can ultimately only present a cosmetic challenge. In other words, it means making **being a cooperative** central to business strategy.

This option requires management to embrace whole-heartedly what it means to trade as a cooperative business in all sectors in which it is trading, and to proactively use, at every opportunity, the advantages and benefits of being member owned and controlled to distinguish themselves from the competition. It does not mean handing over more executive and decision-making powers to democratic bodies – that would fly in the face of good governance, and of providing the best, professional business decision-making model. What it does involve is management treating the factor of being a cooperative as central to business strategy, making it work for the benefit of the business, and making it genuine. That necessarily involves behaving differently from conventional businesses at times when making certain business decisions. For example, whilst the withdrawal of services from a community by the closure of an outlet has to be approached from a financially prudent perspective ultimately it has to be recognised that living by values and principles (rather than maximising shareholder value) can, in some instances lead to a different business decision from that likely to be made by a PLC.

Management therefore have to accept that there are not just differences in process, but sometimes (subject to prudent decision-making and not jeopardising the business) differences in outcome, and they need to be encouraged and rewarded for **delivering cooperative outcomes**.

For members and those involved in the democratic process, there has to be an acceptance that governance needs to be reformed, and that the priorities are for

governance which is objectively more credible in the corporate governance environment which exists today, and for governance which designs into the system a better guarantee of competence and good business decision-making.

The current arrangements in one sense flatter members by the semblance of authority which they appear to have, but which in reality is a flawed system because it masks a level of management freedom and lack of control over management which at times of poor performance have been and will continue to be potentially fatal to cooperative societies, and would have been disastrous but for the ability to transfer engagements. The Cooperative Group has nowhere to which it can now transfer engagements, nor from which it can receive a transfer of engagements in order to deliver another reverse take-over and introduce new management. There is therefore a positive imperative to improve governance, and failure by this constitutional review to do so will leave the Review Board open to criticism in the future if the issue is ducked now, and governance fails in the future in the teeth of a serious commercial downturn.

So at one level, democrats have to be prepared to “let go” (without compromising on member control) by introducing independent directors to provide a more effective counter-balance to the existing executive. At another level, they should look forward to a closer and much more fruitful relationship with management, seeking positively to exploit the advantages of being member owned and controlled, and having within virtually every community in the land people who want the business to succeed because of what it stands for.

Additionally, democrats have to be open to serious and potentially ongoing reform of the democratic structures to support the claim that the organisation is owned and controlled by its members. If that is to be a key part of the strategy in distinguishing the business from investor-owned competitors, that will attract much more debate and scrutiny about the extent to which the Cooperative Group is living

up to its claims. The issues cannot therefore be fudged or avoided.

Owners

Of the three core issues to consider when designing new governance (corporate purpose, ownership and business plan), ownership alone remains to be considered.

The current owners of the Cooperative Group are individual customer or consumer members, and employee members. Employee members are not separately identified by a constituency, but that matter has been raised for consideration in another section⁵¹. Are there any other potential owners to consider?

Cooperatives are designed to be owned and controlled by those who trade with them. Customers and staff comprise the two most obvious categories. There is one further possibility to mention at this stage, namely “non-user investor” members, that is to say people who are neither consumers nor staff, but who support the society by providing funds.

Until recently, the Financial Services Authority would not accept the idea of non-user investors as a category of potential members, but as a result of European legislation which has introduced a new corporate entity where such a category of members will be permitted – the European Cooperative – it has been recognised that if the FSA are not prepared to be flexible by permitting them under UK industrial and provident society law, then the latter legal model might fall into disuse. The discussion paper raising this issue⁵² was published in 2006, and it is not known whether this idea has yet been pursued.

It is not proposed that the concept should be adopted by the Cooperative Group, but it is suggested that the developments should be kept under review.

51 Section number 8

52 Investor Membership of Co-operatives registered under the Industrial and Provident Societies Act 1965, Michael Cook and Ramona Taylor of the FSA

Developing a modernised governance structure for the Cooperative Group

From the above, it will be clear that developing a modernised governance structure to meet current and future needs requires a restatement of the corporate purpose of the Cooperative Group, in today's language and appropriate for the context of today (this is attempted at the end of section 3). Unless cooperation is whole-heartedly embraced once again as the reason for the society's existence, then it raises serious issues about the future. Once a restated purpose is accepted by both management and membership, both groups can work together to decide what arrangements will be most effective to deliver a successful cooperative business, owned and controlled by its members.

There has to be an open debate about what is necessary to secure member control of a national society. If such a debate concludes that some sort of structures are needed at local, regional and national level, then what happens at each level has to be examined to see what works best and delivers the best results for the business of the society. How do management consider that the arrangements can best add value to the business? What arrangements are needed to ensure control by the members? The governance must serve the corporate purpose.

The dialogue between members and management **must not be** a negotiation of changes from the current arrangements. Nor should it be merely a process of horse-trading between existing power bases. Instead, it has to be a joint exploration of the basis for a new settlement, which puts centre-stage the task of challenging conventional businesses by trading as a cooperative. It requires individuals to be prepared to concede historic positions, to take personal risks and maybe to make personal sacrifices.

It requires people to be 21st Century Pioneers.



