Response to Nominet's Governance Consultation on its Articles of Association

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Introduction

Nominet issued a governance consultation on 2nd February 2007 dealing with proposals for possible changes to its Articles of Association. This document is my response.

I served on Nominet's board for eleven years, having helped found it. I suspect I have thus seen many of the challenges Nominet faces with its current governance structure at closer proximity than most of the other respondents. It is possible my previous position might also have coloured my judgment. In any case, I emphasise that this response is made in a personal capacity.

Answers to individual questions

3.1 Board composition - proposals at a glance
• The board should be comprised of up to 9 members:
o Up to 3 executive directors
o Up to 3 elected non-executive directors and
o Up to 3 appointed non-executive directors
• One director will be elected by the membership per year.
• Non executives will serve 3 year terms, and will usually stand down after 6 years.
• The Chairman will be one of the "appointed non-executive directors".
• Appointed non-executive directors will be selected by the board, and the appointment ratified by the membership at the next Annual General Meeting.

Question 1
Do you agree with the proposed changes to Board composition?
I agree with these proposals / I disagree with these proposals/ I would like to make comments

Broadly speaking, the proposals are acceptable, but do not address fundamental problems with the election of non-executive directors (detailed in my response to Question 2).

The proposal to change to three-year terms is much to be welcomed. It is my view, and the view of every non-executive director to whom I have spoken to in the past, that it takes between 9 and 12 months to get fully "up to speed" with Nominet. Thus a two-year term is an inefficient use of time, and means directors are less effective than they should be. This is in no-one's interest. This is, in my view, the single most important change in board structure proposed. It is also probably the least controversial.

It is important to have a board of a workable size, which is balanced between executive and non-executive members. A board of nine directors is in my view workable, but is towards the upper limit of workability; the board should not be larger than this.

I note the same words "Up to" are used in each category; I disagree with this if the words are meant to mean the same thing in each case. I believe that the number of non-executive directors should be fixed (i.e. if a vacancy arises, there should be an obligation on the board to fill it); this should in particular be the case for elected non-executive directors if these are to be retained. On the other hand, providing for "Up to" 3 executive directors provides a welcome degree of flexibility. It should not (for instance) be possible for a board to operate on an ongoing basis with 3 executive directors, and one (or even zero) non-executive directors of each category. I note this interpretation is wider than the proposed articles at EGM1.

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The annual election and ratification of one of each type of director is a welcome simplification to the current process.

I do not believe it is necessary to specify within the articles from which category of director the chairman would come; it is natural that the chairman would normally come from the appointed non-executive directors. However, in the event of the chairman leaving without notice, it would not be helpful to proscribe that a chairman acting in an interim capacity should come from one particular set of directors. I would suggest that the board should appoint its own chairman. Good corporate governance principles should do the rest. Such principles do not need to be incorporated into the articles; Nominet should adopt a "comply or explain" philosophy, just as quoted companies do.

The consultation is unclear as to what it intends in respect of term limits. Under 3.1 it states "Non-executives … will *usually* stand down after 6 years" (my italics). But under 3.1.2 and 3.1.3 it states "… non-executive directors would stand down in compliance with corporate governance best practice, which would *currently* be after two terms (6 years)" (again, my italics). This raises two questions: whether this is a hard limit incorporated into the articles or a "comply or explain" proposal; also whether it is proposed to link any limit to any future changes in thoughts as to corporate governance. In fact, the Higgs report is far more nuanced in respect of term limits than the consultation suggests, and nowhere does it suggest term limits are incorporated into the articles of association of companies; rather, it suggests that companies adopt a "comply or explain" position, and members vote accordingly. My position is set out below.

In respect of elected non-executive directors (if these are to be retained), it is entirely illogical to impose a term limit; doing so prevents the membership from electing a person they might otherwise want to elect. Given the entire justification for elected non-executives is to give the membership an unfettered choice of candidates, term limits for such directors are illogical. I would therefore suggest instead that Nominet points out above the election statement for any candidate that stands as an elected non-executive director any breach of corporate governance principles if the director were to be elected (this would then cover, for instance, close relatives of executives, ex-executive directors etc. standing as well), and the membership could make an informed decision; see my answer to Question 3 for further details.

In respect of appointed non-executive directors, there is a better argument for a term limit. However, I see no reason to impose a hard limit. An obligation to comply or explain, particularly at the point where ratification of the director's appointment is sought should suffice, as it does for quoted companies. It is again better for the membership to make their own mind up at the time with the full facts than codify somewhat arbitrary limits within the articles.

3.1.1 Executive Directors

Current situation

- 2 executive directors, one of which is the managing director.
- The managing director shall be the Chairman.

What we would like to do

- Increase the number of executive directors to a maximum of 3 (one of whom will be the Chief Executive).
- Not require the chairman to be an executive director.
- The members' ability to remove any director from office would remain unchanged.

Why change?

- In companies of Nominet's size, it is usual for the chairman to be a non-executive role.
- As Nominet matures and develops, it may require more executive directors to have day-to-day responsibility for the business.

Question 2

Do you agree with the proposed changes to executive directors?

I agree with these proposals / I disagree with these proposals/ I would like to make comments

I agree with these proposals. It should not be necessary to specify within the articles that the "Chief Executive" is one of the executive directors; the board should simply have the power to appoint up to three persons in the Company's employment as directors. See my answer to Question 1 re the Chairman.

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3.1.2 Elected Non-Executive Directors

Current situation

- 4 non-executive directors, elected by the membership.
- 2 directors elected by weighted voting per year.

What we would like to do

- Retain the membership vote for elected members at the Annual General Meeting.
- Alter non-executive directors' term of office to 3 years – in compliance with corporate governance best practice.
- Elected non-executive directors would stand down in compliance with corporate governance best practice, which would currently be after two terms (ie 6 years)
- Decrease the number of elected non-executives to 3.
- The net effect would be that one non-executive director would be elected in each year, simplifying one aspect of the election process.
- Add the ability of the Board in the case of a vacancy arising on the Board to co-opt as a director a person who is willing to stand until the next Annual General Meeting

Why change?

- The board believes it is important to retain direct membership influence at the heart of the business.
- Corporate governance best practice emphasises the need to have the most effective board for the company. The balance of skills and experience on the board is a key element of this. To obtain the best board, the elected non-executives should be balanced with appointed non-executives.
- The overall board size should remain small enough to be efficient and functional.

Question 3

Do you agree with the proposed changes to elected non-executive directors?

The wish to retain "direct member influence at the heart of the business" is laudable but, in the current environment, problematic. In the last election, 265 members voted, 9% of the electorate. This is a miserable turnout, despite introduction of electronic voting. Poor turnout has been ascribed to several things, including members believing (i) that "everything is working fine so why do we need to vote" and/or (ii) that it is not possible to make an informed decision on who to vote for given lack of information on candidates or time to vote. Nominet currently does not make recommendations on whom to vote for, thus depriving members of another possible source of information on how to vote. Nominet's directors have a duty to the Company which includes selection of competent staff; however, Nominet itself currently adopts less care in selecting non-executive directors than it does in selecting its most junior staff. Members, the majority of whom are busy with their own businesses, have scarcely more time, and have to rely on the unverified claims of candidates. The low turnout puts the election in the hands of a small minority of members, many of whom often appear more influenced by the "campaign issues" than the suitability of particular candidates; this is to misunderstand that a director is not a delegate, but effectively a trustee. Note this is not a criticism of any particular director past or present (after all, I was arguably the greatest beneficiary of this system), but of the election system in the current environment.

My preference would be to abolish elected non-executive directors entirely, and instead have six appointed non-executives, serving three year terms, but with a greater degree of member sanction if this proves necessary (for instance, it could be provided that no such appointment would take effect without member approval, rather than allowing for subsequent ratification). This would provide a far simpler and more understandable system. I suspect this would be unacceptable to sufficient members that 75% support would be difficult to attain.

A less effective but more palatable alternative would be for a nominations committee consisting of (for instance) the appointed non-executive directors to produce recommendations on the candidates standing as non-executive directors, which would be published with the voting papers. These recommendations could be drawn up after interviewing all the candidates, and after references were taken. Members should then be given the option of lodging a permanent but revocable proxy to vote according to the views of the nominations committee; this would presumably suit all those who believe the company is running sufficiently well not to vote. All members would, of course, retain the option to vote if they wished. At the same time, the nominations committee would list any corporate governance concerns about the candidates standing (for instance serving more than six years). Whilst participating by giving a proxy is, arguably, only

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a poor form of participation, I believe this would increase participation levels without removing members' rights to directly participate should the need arise.

On a separate point, now polls can be taken electronically, it should not be necessary to hold the poll simultaneously with the Annual General Meeting. Ideally, polls should be held immediately before it, so that the results are known at the AGM. This would give the opportunity for the board and the members to thank any elected non-executive director who is voted out and, more importantly, allow the results to be announced to the meeting. The change in board composition could still, of course, take effect at the AGM.

3.1.3 Appointed Non-Executive Directors

Current situation

- There are no appointed non-executive directors
- 4 non-executive directors (2 per year) are elected by Nominet's membership

What we would like to do

- Introduce a new category of "appointed non-executive director", who would be selected by the board and the appointment ratified by the membership at the next Annual General Meeting.
- There would be up to 3 appointed non-executive directors.
- The Chairman would become an appointed non-executive director.
- Appointed non-executive directors would retire by rotation based on who had been longest in office.
- Appointed non-executive directors would stand down in compliance with corporate governance best practice, which would currently be after two terms (ie 6 years).

Why change?

- Corporate governance best practice is that a board should have a balance of skills and experience, sufficient for the company's needs.
- Few candidates through the election process in recent years have had experience of running a business the size of Nominet.

Question 4

Do you agree with the proposed changes to appointed non-executive directors?

I agree with these proposals / I disagree with these proposals/ I would like to make comments

I agree. As per my answer to Question 3, I believe Nominet should ideally replace all elected non-executive directors with appointed non-executive directors. See my comments above re term limits, and specification of the Chairman role.

Some members have voiced concern that in the articles as presented under EGM1 there appeared to be few checks on how appointed non-executive directors were appointed; particularly significant are the ability to appoint just after an AGM thus avoiding ratification for an entire year, and the ability to appoint a person who has received a negative ratification vote. I agree with these concerns; whilst these are mainly matters of drafting rather than of principle, I believe there *is* a matter of principle that the drafting should be sufficiently tight that a board cannot ride roughshod over the wishes of members. Balanced against this, I believe the board should have the flexibility to co-opt board members between AGMs to fill vacancies, at least in small numbers. I would suggest: (1) the Board's selection prior to an AGM should be conditional on (as opposed to ratified by) a member vote, and the required majority for that vote should be 50%; and (2) that the Board should be able to co-opt any person to fill a vacancy (other than a vacancy by normal retirement which should be filled as above), but cannot co-opt any person who within the past three years has suffered a negative ratification vote, with a maximum of one such co-opted person between each AGM and with any co-opted persons being subject to a positive 50% majority vote at the next AGM (as required by company law).

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3.2 Other proposals
There are numerous other provisions relating to directors, which we propose to change to bring them in line with corporate governance best practice, and legal drafting best practice. As part of this, it is proposed to incorporate Table A of the Companies Act 1985 (as amended by Table C so that it is appropriate for a company without a share capital). They are as follows:
…detail removed …
Question 5
Do you agree with the proposed other changes relating to directors?
I agree with these proposals / I disagree with these proposals/ I would like to make comments

I agree with these proposals with the exception of the proposals concerning alternate directors.

Alternate directors are appropriate in scenarios where directors are elected to represent the concerns of different classes of shareholder or different large shareholders. This is the antithesis of what Nominet should be trying to achieve. Directors should be appointed as to their personal qualities, experience, and suitability. The ability to appoint an alternate allows a director to appoint a substitute of unknown quality. If the concern is to ensure meetings are quorate, or to avoid meetings being called in a manner where busy directors are less likely to be able to attend and thus have their say, then alter the quorum and/or notice requirements for meetings. I believe alternate directors should not be permitted.

4. Policy
Current situation
• Although Nominet always consults with relevant stakeholders, including the PAB, on policy issues, there is no requirement in the articles to do so.
• Currently the articles say that the membership will “consider technical issues relating to naming the .uk domain; and advise the [board] on such matters”. The articles also state that the board will “have regard to any regulations made by the [membership]”, but do not give any power for the membership to make regulations!
What we would like to do
• Enshrine the company’s practice of consulting relevant stakeholders on policy issues.
Why change?
• Consultation with relevant stakeholders is at the heart of our community orientated ethos, and is necessary for fulfilment of our mission “to excel in the management of the .uk domain and the provision of registry services in response to the needs of our customers and stakeholders”
Question 6
Do you agree with the proposed changes to policy?
I agree with these proposals / I disagree with these proposals/ I would like to make comments

I agree.

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5. Fees

Current situation

• The board has no ability to change the level of registration fees or membership subscriptions. All other fees (eg DRS, tag change, transfers, DAC, PRSS) can and are implemented and changed by the board.

• A change in registration fees or membership subscriptions would require a ballot of the membership, and can only be implemented on a 75% majority.

What we would like to do

• Give the board the ability to regulate sale price as well as costs, by giving the directors the power to change all fees. Any fee changes would, naturally, be communicated with appropriate notice.

Why change?

• The Board needs to be able to respond swiftly to changes in the domain name market, be they competitive pressures, economic downturn, or other market changes that could impact the long-term performance of the Company. The current process for fee change is slow and cumbersome, and would place us at a considerable disadvantage to any competitors.

• Directors have a legal responsibility for running the company, but at present do not have the usual tools to allow them to do so, because they do not have the ability to regulate the company's income through setting the level of fees.

Question 7

Do you agree with the proposed changes to fees?

I agree with these proposals / I disagree with these proposals/ I would like to make comments

I agree in the main. The principle that the board should be day-to-day in control of the Company's commercial business is a key one. It is questionable to what extent the board can exercise it fiduciary duties when hamstrung by a clause such as the current 19A. Thus the ability to change prices without cumbersome procedures is key; my overall view is thus that this is an important move in the right direction, but I have a number of concerns set out below.

With the specific issue of membership fees (by which I mean the amount of money required to become a member, and thus have a vote, as opposed to any fees for gaining registrar status), some members have an understandable concern that the board could unilaterally raise fees and thus disenfranchise them. Having listened to members' arguments, I understand these concerns and have changed my mind. Given that membership fees are a comparatively small part of Nominet's income, and given that this affects voting and thus control of Nominet rather than a merely commercial issue, I believe it is important to address these concerns. I cannot see any realistic way of addressing these concerns without making any change to membership fees subject to a member vote. I would, however, suggest it should require an Ordinary rather than a Special resolution.

With regard to registration fees, there is a concern on the part of some members (i) that these could be set in a discriminatory manner, (ii) and that "bulk discounts" could be introduced. Whilst I understand these concerns, I believe Nominet is adequately protected by the duties on directors to act in the Company's best interest (and thus that of its members as a whole) in respect of both concerns. In respect of (ii), I believe that bulk discounts are probably a sensible response to the long tail of members registering very small numbers of domain names. Putting every change in bulk discount to a vote would be unmanageable, and cause a number of "game-theory" type issues in the voting. Management should be spending its time managing the business, rather than with such politics.

If members fears need to be allayed I would suggest introducing a carefully drafted article which would prohibit discriminatory pricing (albeit that past experience in regulated industries has shown that apparently non-discriminatory pricing can in practice discriminate), and a provision that any changes in domain name registration pricing must also be approved by a committee of the board composed only of directors having no material connection to domain name registration businesses (other than Nominet) having regard to this principle of non-discrimination, in addition to approval by the board as a whole. Further, all pricing should be published (this too could be incorporated into the articles). This should focus the mind of the directors concerned on their duties in law.

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Concluding matters

I believe the session after the AGM was a useful two-way process for interacting with members and hearing their concerns. Whilst I don't think one can conclude that the views put forward were universal or even necessarily representative, I think they gave useful food for thought.

I believe the most controversial issue is likely to be pricing. Whilst I agree that it is undesirable to present members with a "Chinese restaurant menu" of different options, it does seem that the pricing issue itself is separable. If the consensus on pricing is substantially less clear than on other issues, I suggest the way forward should be to present a new set of articles retaining equivalent of the current 19A, and a further resolution (conditional on the passing of the first) to remove that clause or substitute it for an alternative clause as proposed by the board. I believe this could be explained in a sufficiently clear manner that it would not put members off responding.

As always, the proof will be in the pudding, and it will be necessary to judge the proposals based on final drafting.

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