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SECTION 3, PART 5
CORPORATE GOVERNANCE, MANAGEMENT AND INCENTIVISATION

CORPORATE GOVERNANCE

1. INTRODUCTION

Corporate governance is the system by which companies are directed and controlled. It deals largely with the relationship between the constituent parts of a company - the directors, the board (and its sub-committees), the shareholders, and occasionally other key stakeholders. The governance of Government owned businesses should, wherever possible, reflect commercial best practice – namely the principles of the Combined Code on Corporate Governance.

1.1. Combined Code on Corporate Governance

The Combined Code contains general principles and more detailed provisions relating to the corporate governance of listed companies. The Code is appended to the Financial Services Authority's (FSA) Listing Rules which place a regulatory requirement on companies, in their annual report and accounts, to:

i. report on how they apply the principles of the Code; and
ii. confirm that they comply with the Code's provisions or, where they do not, provide an explanation.

This is known as the 'comply or explain' principle which, if applied effectively, underpins informed dialogue between directors and shareholders. The code sets out standards of good practice in relation to issues such as:

- board composition
- roles and responsibilities
- appointments and remuneration
- accountability and audit; and
- relations with shareholders

The Combined Code was revised in 2003 following the Higgs Review, an independent review commissioned by the then Trade Secretary, Patricia Hewitt and Chancellor, Gordon Brown, which looked at the role and effectiveness of non-executive directors. The revised code includes some useful suggestions for good practice from the Higgs report, including guidance for non-executive directors, duties of committees and checklists for due diligence, inductions, and performance evaluation.

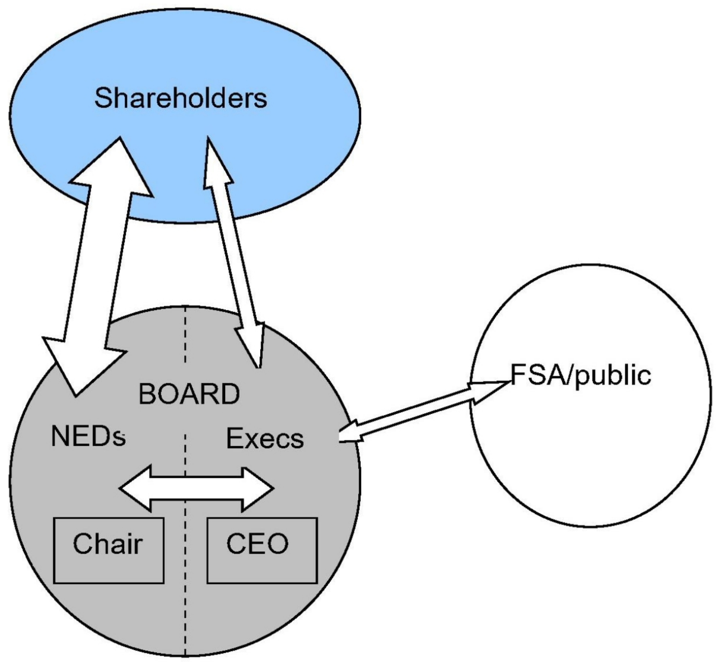
The full document can be accessed via the link below:-

http://www.fsa.gov.uk/pubs/ukla/lr_comcode2003.pdf

UKGI00044314

1.2. Key principles of the Combined Code on Corporate Governance

The Code sets out a model of governance for listed companies, which is based on the ethos of informed dialogue between all parties. It could be represented by the model below:



The Code contains 14 main principles for the corporate governance of companies, which are supported by 48 code provisions. It is these provisions to which companies must confirm that they comply, in their annual reports. More detail on the provisions and principles of the code are explained in the following sections and in the Management Incentivisation section of Section 3, Part 5.

2. CORPORATE GOVERNANCE FOR GOVERNMENT BUSINESSES

2.1. The Shareholder Executive model of corporate governance

The Government intends to operate as an intelligent and informed shareholder. For its businesses to succeed the government, as shareholder, needs to apply a consistent approach across the portfolio. In developing a model for managing the government's shareholdings ShEx examined a number of private sector comparators. While no single shareholder model is applicable in its entirety, the government's position as a significant (in most cases 100%) shareholder means that many features of the private equity model are relevant to the management of government shareholdings. ShEx has therefore adapted this model to recognise, in particular, the longer-term nature of the government's financial interest in its businesses and the non-commercial policy objectives it sets.
Recognising that it may not be suitable to use a one size fits all model, the following principles for corporate governance should be followed for all ShEx businesses:

UKGI00044314

- should be compliant with the Combined Code, unless there are specific reasons to deviate in individual cases
- must fit the needs of the shareholder and the business
- must provide clarity of roles and responsibilities
- should be based on an ethos of informed dialogue between all parties

The rest of this section sets out more specific principles to guide behaviour of the government as shareholder – the '**Government Shareholding Principles**' which incorporates how the Government intends to operate as a Shareholder, and what it expects of its businesses, as summarised below:

1. How the Government intends to operate as shareholder

The basic shareholder model as set out below summarises the key actions of the shareholder and its interactions with the businesses.

The Basic Shareholder Model

- The shareholder appoints the board, and agrees the terms on which the directors are appointed and incentivised (annually and for the longer term)
- The shareholder sets overall objectives for the business
- The shareholder agrees the business' strategic plan with the board
- The board is accountable to the shareholder for delivering the agreed plan
- The shareholder gives the board the operational freedom to take the action necessary to deliver the strategic plan
- The shareholder monitors the performance of the business to satisfy itself that the strategic plan is on track and ensure that any interventions required are well informed and appropriate.

Picking up the principles which are particularly concerned with the governance of the business, the following framework provides a basis upon which ShEx should work to apply a consistent approach to governance across its portfolio.

Governance Framework

i. Shareholder teams should set out, for each business, a single document ("governance letter" or similar) describing the rights and levers held by the shareholder, and how they intend to use them, as well as any specific requirements arising from the businesses legal framework, government ownership and policy objectives. The document should also set out the rights and responsibilities that have been passed to the board.

ii. Shareholder teams should adopt a systematic approach to encouraging business to apply best practice corporate governance.

Section 6.2.4 below goes into more detail on governance documents and provides examples which can be used as a template.

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2. What Government expects of its businesses

Government set out nine key principles which the government expects to govern the behaviour of businesses in government ownership. These principles are grouped under the themes of Communication, Financial, Shareholder Value, Strategic, and Social, ethical & environmental. Those which have particular relevance to the Corporate governance of a business are replicated below.

Principle 1 Businesses should seek an **honest, open and ongoing dialogue with the government as shareholder**. They should clearly communicate the plans they are pursuing and the likely financial and wider consequences of those plans. Ideally, goals, overall plan and progress should also be made public and discussed in the annual report and accounts.

Principle 2 Businesses should operate **a "no surprises" policy** ensuring that the government as shareholder is informed well in advance of anything potentially contentious in the public arena.

Principle 5 Businesses should have performance evaluation and incentive systems designed cost effectively to **incentivise managers to deliver long term shareholder objectives and shareholder value**.

Principle 8 Businesses should have and continue to develop coherent strategies for each business unit. The **approach to reviewing strategy should be a dialogue between the board and the shareholder**. The focus of the dialogue should be set by the primary goal of the board to deliver the business's objectives, which will include key commercial, financial and non-commercial goals, including the maximisation of shareholder value consistent with the non-commercial objectives. Strategies should include a market and risk analysis, benchmarking, relevant sensitivity analysis, contingency plans and an outline of how the proposed strategy takes account of lessons learned from previous performance.

For the full text on the 'Government Shareholding Principles' see the ShEx Annual Report 2004-05, Annex D via the link below: http://www.shareholderexecutive.gov.uk/publications/pdf/annualreport0405.pdf)

2.2. The role of the Shareholder and ShEx

The role of the shareholder, in respect to a company's corporate governance, is principally to ensure that it is satisfied with the governance arrangements, and that such arrangements are compliant with the Combined Code (where appropriate).

The Combined Code includes provisions for the duties of institutional shareholders, principally that they 'should enter into a dialogue with companies based on the mutual understanding of objectives', and that they should undertake to evaluate companies' governance arrangements, giving due weight to any relevant factors drawn to their attention.

The Corporate Governance objectives of Government, when a shareholder, are the same whether ShEx is acting in an 'Executive' or 'Advisory' role. As set out in Section 2 ('The Shareholder Executive Offering'), however, the ability for ShEx to fully apply the controls and levers in this area, may be diluted when working through a separate Shareholding Department.

UKGI00044314

As acknowledged in the 2007 NAO and PAC reports, ShEx is most effective in an executive role and accordingly ShEx is seeking a full Executive role, with full ownership of all shareholder levers, including governance or, where in an advisory role, recognition and acceptance from the shareholding department that they will comply with ShEx best practice in such areas as governance.

2.3. Peculiarities of Government businesses

The nature of some Government businesses may lead to inconsistencies with the principles of good corporate governance. The sections below, copied from section 1 "Introduction" to the ShEx Handbook, outlines the corporate governance frameworks for each type of Government business:

i. Trading Funds

The relevant Minister is ultimately responsible to Parliament for the performance of the trading fund. For most trading funds, the ShEx objective has been to bring corporate governance in line with commercial best practice through the appointment of non-executive Chairs and ensuring the quality of other non-executive directors. The boards are then given collective responsibility for the performance of the business. It should be noted, however, that unlike under the Companies Act framework, it is the relevant Chief Executive, rather than a collective board, who is the 'Accounting Officer' for each of the trading funds, personally responsible to Parliament for the 'propriety, regularity and value for money' of all expenditure. The ShEx seeks to ensure that the corporate governance arrangements are not in tension with the personal responsibilities of the Accounting Officers, though some of the CEOs find this difficult which can make it a potential inhibitor of the ShEx governance model effectiveness. The flipside of the trading fund model is that board members, other than the CEO, do not have formal accountability for performance or operation of the fund, although they are personally and morally responsible by nature of their appointment.

ii. Companies Act Companies

Governance as any Companies Act company. The ShEx would expect the businesses to be compliant with the Combined Code (see section 6.1.2), where the company is managed by a Board, presided over by a Chairman and includes executive and non executive directors. Collectively, the Board is legally responsible for the success of the company and the Directors have personal financial liability. The relevant Departmental Minister is still responsible for the Govco as a departmental asset.

iii. Statutory Corporations

Governance as set out in the legislation for each Statutory Corporation, but would normally be similar to the Companies Act model where the management of the company is delegated to the Board, presided over by a Chairman. Broadly, the Courts would regard Board members as having the same fiduciary responsibilities as the directors of a Companies Act company. There are, however, some oddities within the ShEx portfolio: British Waterways, for example, has an entirely non-exec board, and Channel 4's board are appointed by the regulator, Ofcom.

For example the Channel 4 legislative basis for corporate governance is set out as follows, in the Broadcasting Act 1990:

http://www.opsi.gov.uk/acts/acts1990/ukpga_19900042_en_3#pt1-ch2-pb2-l1g23

UKGI00044314

Channel 4

23. The Channel Four Television Corporation

There shall be a corporation to be called the Channel Four Television Corporation (in this Part referred to as "the Corporation").

The Corporation shall consist of—

a Chairman and a deputy Chairman appointed by the Commission; and

such number of other members, not being less than eleven nor more than thirteen, as the Commission may from time to time determine.

The other members referred to in subsection (2)(b) shall consist of—

persons appointed by the Commission; and

ex-officio members of the Corporation;

and the total number of members appointed by the Commission under subsection (2)(a) and paragraph (a) above shall exceed the number of ex-officio members.

Any appointment made by the Commission under subsection (2)(a) or (3)(a) shall require the approval of the Secretary of State.

For the purposes of subsection (3) the following persons shall be ex-officio members of the Corporation, namely—

the chief executive of the Corporation; and

such other employees of the Corporation as may for the time being be nominated by the chief executive and the Chairman of the Corporation acting jointly.

Schedule 3 to this Act shall have effect with respect to the Corporation.

iv. Public Private Partnerships

The PPPs that ShEx are involved in, are Companies Act companies and will therefore be subject to the relevant standard legislation, although there may be bespoke Shareholder Agreements that impact on the Governance as well. For example, on NATS on Working Links there are shareholder representatives on the Board and who, arguably, are not truly independent NEDs from a Combined Code perspective.

2.4. Communicating the governance framework

The documents which set out the corporate governance framework for a business are a key component of the ShEx governance approach. Taken together the documents should:

1. Clearly set out the purpose, role and objectives for the business + HMG strategic intent (where relevant);
2. Clearly communicate the role and responsibilities of all parties involved in governance of the business, including (but not limited to) the Board, Chairman, Chief Executive, Shareholder Department and and ShEx;
3. Set out the Government's Shareholding Principles (see Section 1)
4. Describe the governance rights and levers, and how they will be used
5. Describe the policy and financial framework within which the business is constrained e.g. Ministerial consents, reporting requirements, liabilities, dividend policies etc.

Corporate Governance documentation will normally be additional to the Articles of Association which all Companies Act have, and which set out how the company is

UKGI00044314

organised and how it works. Ideally a complete set of governance documents will include:

1. **Chairman's letter**
   Description of the responsibilities of the Chairman, personal objectives (e.g. reform the Board) and top level strategic objectives for the business. Should include a description of the wider governance framework.

2. **Governance letter**
   Detailed description of the governance arrangements for the business and further detail on the policy and/or financial frameworks.

3. **Shareholder relationship or Delegated remit letter for ShEx (where appropriate)**
   Formal delegation of responsibilities to ShEx from shareholding department.

More explanation of the Chairman's letter can be found in section 6.5.1. The appendices include a proforma which can be used as the basis of a governance letter, framework document or shareholder relationship letter. The following examples can also be used for guidance, and are located in the appendices in hard copy form.

Outline governance letter / framework document

Outline governance
letter framework do

UKAEA Chairman letter

Example UKAEA
Chairman letter.tr5

Royal Mint Chairman letter

Example Royal Mint
Chairman letter.tr5

DSTL framework document

Example DSTL
framework document

Royal Mint delegated remit letter

Example Royal Mint
ShEx delegated remit

Actis Shareholder relationship letter

Example Actis
Shareholder Relation

3. BOARD COMPOSITION, ROLES, & RELATIONSHIPS

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3.1. Board composition

The Board is collectively responsible for the success of any company. It should include a balance of executive and non-executive directors (and in particular independent non-executive directors), which should ensure that no small group can dominate the board's decision making. The Combined Code specifies that in all but small companies at least half the board, excluding the Chairman, should be independent non-executive directors. A smaller company should have at least two independent non-execs.

One of the key actions of ShEx when taking on responsibility for Government businesses has been to appoint a non-executive Chair and directors to reflect the Combined Code principles, particularly for businesses such as Trading Funds which have often in the past had Boards made up solely of Executive directors.

The starting point for board appointments should be an agreed vision between ShEx and the Chair of the mix of skills and experience for the board as a whole. This will depend on the business and the nature of the challenges both in the short term and long term, but some suggestions of core competencies for Chair/CEO/FD can be found in the appendices.

3.2. Roles & Division of responsibilities

The principal Board roles and their key responsibilities are:

Chairman	- responsible for establishing and agreeing broad strategy with the key stakeholders; - responsible for managing the Board and making changes when and where required;
Non-Execs	- responsible for scrutinising performance of executive team in delivering agreed stategy; - responsible for determining appropriate levels of remuneration for executives and supporting Chair in appointments and/or changes to the board;
MD/CEO	- responsible for implementing the agreed strategy and managing the executive team on a day to day basis;
FD	- responsible for financial management of the business and producing appropriate financial information on a timely basis;

One of the key principles of the Combined Code is that there should be a clear division of responsibilities at the head of the company between the running of the board and the executive responsibility for the running of the company's business. ShEx should also seek to ensure that businesses follow other related provisions in the code, in particular around the independence of Chairmen.

It is the Chairman's responsibility to lead the board, and ensure it is effective in its duties. It is also the Chairman's responsibility to ensure effective communication with the shareholder, and therefore it is normally the Chair with whom ShEx will have most contact. Good working relationships between ShEx and the Chair are vital to ensure successful implementation of the shareholder model.

UKGI00044314

Division of responsibilities should be clearly set out in the Chairman's letter, and also in Governance letters, where appropriate – see section 6.2.4.

3.3. Shareholder Relationship with Board

There should be regular communications between the board and the shareholder. ShEx would want to have a good working relationship with the board via direct communication, even where working in an Advisory capacity. ShEx will seek to have direct communication and access to all the key Board members, such as Chairman, NEDs, CEO and FD, so that there is a broad understanding of different perspectives and that ShEx's understanding of the business and its performance is not filtered via a single relationship with the Chairman, or CEO.

3.4. Board Representation/Observer Status

In general, ShEx does not appoint members of its team directly to the Board of Government-owned businesses. This avoids potential conflicts of interest between ShEx's shareholder role and the fiduciary duties held by any director of a business. ShEx can seek, subject to the individual business governance arrangements, to attend board meetings as an Observer, which has the advantages of:

i. ShEx being able to observe the Board in action and the dynamics and contribution of the Board and its members;
ii. Being close to key issues and discussions and not having information filtered or sensitised prior to ShEx receiving it;
iii. Avoids duplication for the management team i.e. having to review performance both with the Board and then ShEx;
iv. Allows closer relationships to be established with the Board.

4. OBJECTIVE SETTING

Shareholding teams should systematically, and in consultation with management, identify and, where possible, publish objectives for their businesses (except where there is commercial sensitivity, which may be agreed and documented separately with the Board)

Shareholding teams should take responsibility for resolving any conflicts and trade offs between the government's objectives and this is an area that is more fully covered in Section 3, Part 4 (Framework, Strategy and Objective Setting).

Chairs and senior non-executives should share the shareholder's view about the objectives for the business. Incoming Chairs should meet the shareholding minister to discuss these objectives before taking up their appointments.

As above, ensuring the board has absolute clarity of objectives from the shareholder is a key role and function of ShEx and is covered more fully in Section 3, Part 4.

5. BOARD APPOINTMENTS

The starting point for board appointments should be an agreed vision between shareholder teams and the Chair of the mix of skills and experience for the board as a whole (see para 3 on board composition). A board nominations committee, or appropriately constituted appointments panel comprising the Chair, an independent member and one or more Government representative, should be used to recommend specific appointments to the shareholding minister. This process needs to mirror

UKGI00044314

OPCA requirements (see below), which therefore usually takes precedence over the role of the Nominations Committee, particularly if there is any conflict between the two.

The key appointments to a Government owned business are Chairman, Non-Executive director(s), CEO, and FD. The ShEx team will/should be fully involved in the recruitment of all these key appointments which will encompass:

i. thinking about the needs of the business and an appropriate specification of the target candidate;
ii. agreeing the right recruitment/selection process that meets relevant Public sector guidelines (see section xx);
iii. agreeing to and/or procurement of appropriate consultants to conduct the recruitment, where necessary;
iv. ensuring appropriate incentive arrangements are approved and in place to secure an appropriate candidate;
v. participating in the interview/selection process;
vi. ensuring that appropriate objectives are in place for the appointed candidate, aligned to the agreed framework & objectives for the overall businesses.

5.1. Chairman

The role of the Chairman

There are various descriptions of the Chairman role. Appendix X is an extract from the Combined Code on Corporate Governance, the ShEx reference model for Governance, which provides a summary of the role. This guidance note can be attached to the Chairman appointment letter for reference purposes, particularly where the appointee is new to the Chairman role and/or the ShEx team has not worked with the individual previously.

Note: the whole document can be found at:-

Combined Code on Corporate Governance. PDF

When appointing a Chairman and setting appropriate objectives, etc, the ShEx must always be mindful of the wider duties and legal obligations that a Chairman might be under via the Companies Act or other legislation specific to that Government owned business and that the ShEx's requirements should not be in conflict with these wider responsibilities. This is commented on further below.

Chairman Recruitment

Section 5.4 provides information on management selection and recruitment. This includes a list of suggested core competencies for a Chairman and some sample interview questions for testing their fit against the competencies although these will, of course, vary from business to business.

The Chairman role and the impact of the Government Legal Entity

As highlighted in Appendix 2 of Section 1, the Introduction to the handbook, Government owned businesses exist in various forms of legal entity. As described in section 2.3 the context for the Chairman role may vary between businesses, partly dependent on the type of legal entity the business falls within.

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Despite the historical corporate governance peculiarities of some businesses ShEx has endeavoured to introduce a model of corporate governance based on best practice seen in the private sector – that is, a board led by a non-executive Chair and composing a mixture of executive and non-exec directors who are jointly responsible for the performance of the business.

Chairman Appointments

ShEx can have a large impact on the effectiveness of the Chairman appointed by ensuring that:

i. A comprehensive briefing or introductory pack is prepared about the business, its activities, its financial performance and communication of the ShEx assessment of the key issues and actions required;
ii. A smooth introduction to the key members of the executive management team and that any issues in this respect are addressed by ShEx rather than faced by the Chairman alone;
iii. A clear set of objectives are established for the Chairman by which they will be assessed. These objectives should be reviewed annually and potentially updated to ensure that any new external of internal issues or priorities are factored in to a revised set of objectives.
iv. An agreed monitoring or meeting schedule so the Chairman knows how often he/she will be meeting the ShEx team and the basis for any performance review.

Chairman Appointment letter

The Chairman Appointment letter is a key component of the ShEx governance approach for the following reasons:

i. It provides a focus to ensure there is a clear communication of the objectives that have been established for the business and/or the process by which the objectives will be agreed if not already in place;
ii. It clearly articulates what is expected of the Chairman;
iii. It is a means by which the performance of the Chairman can be judged and facilitates action in the event of underperformance, if required;
iv. It sets out the relevant formal aspects of the appointment, encompassing pay, contract period, conflicts of interest (where Government may take a more aggressive view of what constitutes a conflict that the private sector), etc;
v. It sets out the context of the wider governance arrangements for the business and hence where the Chairman role fits within this.

A proforma appointment letter can be found at Appendix XX which sets out the main sections of a standard letter and a number of real examples that have been used on the portfolio. It should be noted that legal advice should be taken on any specific letter prior to issue to ensure compliance with the latest best practice and legislation at that time.

Proforma Chairman Appointment Letter.t

Example Royal Mint Chairman letter.tr5

Example Scottish Water Chairman lette

Chairman Monitoring and Review

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The suggested monitoring and review process for each Chairman appointed by ShEx is as follows:

- a formal annual review to assess progress versus the agreed objectives, with revised objectives established for the following year, if appropriate;
- a quarterly or half yearly review meeting, to discuss the business and management performance and key issues either from the ShEx of the Chairman's perspective. In so doing, ShEx can form a judgement on whether the Chairman is on top of all the issues, whether they are action orientated and assess whether they are happy with the Chairman input and role in the business. This would be enhanced if a ShEx representative attended some/all Board meetings (e.g. as an Observer), to see how the Chairman managed the Board;
- ad hoc phone calls and meetings as appropriate.

The level of contact may need to be increased when there are specific projects or issues facing the business such that the ShEx is more hands on and needs a closer working relationship with the Chairman.

The appendices provides a checklist of evaluation questions for NXDs that has been extracted from the Combined Code). This can be used as a basis for the formal review with the Chairman that should take place on an annual basis, as a minimum.

Non-Executive Director Assessment.

Changing a Chairman

At times the ShEx will need to change Chairman, either because of underperformance of the incumbent; because a new candidate is required as a result of a fundamental change in the business (e.g. a privatisation is taking place and someone with quoted company experience is required) or simply as part of a 'refresh' process in line with the Combined Code.

Where an existing candidate is to be replaced, it is important that ShEx takes legal advice regarding the contractual and employment rights of the Chairman. Key questions would include:-

- Are there notice provisions?
- What compensation rights does the Chairman have in the event of loss of office?
- Is there any threat of a claim for unfair dismissal?

In addition to the legal position, there may also be moral considerations and if the Chairman is to be removed for performance reasons, then the termination meeting should not be the first time that they have heard of any issues in relation to their performance in their role.

Chairman - Summary

The Chairman appointment is a key component of the ShEx model and significant attention must be paid to:

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i. Establishing the specification for the Chairman role. Whilst there will be a core component that is consistent to every Chairman appointment, there will also be a large variable component in terms of personality fit with the management team and sector or situational (turnaround, PPP, etc) experience that will need to be assessed on an appointment to appointment basis;
ii. Ensuring the right incentive mechanisms are in place to secure the best candidate;
iii. Managing the selection process to attract the right candidates;
iv. Selecting and appointing the right candidate;
v. Introducing the candidate to the business and establishing clear objectives and framework for the role;
vi. Monitoring and assessing performance versus the agreed objectives.

This is an active process, requiring sufficient time and resource to ensure the right Chairman is appointed and retained who delivers what the ShEx expects in terms of performance.

5.2. Non-Executive Directors (NXDs, or NEDs)

NXDs are a key addition to the board of any business. From a Companies Act perspective, NXDs are directors of the board and have the same fiduciary duties and responsibilities as the executive directors. As set out in the Combined Code, the role of the NXD has the following key elements:-

Strategy – NXDs should constructively challenge and help develop proposals on strategy.

Performance – NXDs should scrutinise the performance of management in meeting agreed goals and objectives and monitor the reporting of performance.

Risk – NXDs should satisfy themselves on the integrity of financial information and that financial controls and systems and risk management are robust and defensible.

People – NXDs are responsible for determining appropriate levels of remuneration of executive directors and have a prime role in appointing, and where necessary, removing executive directors and in succession planning.

The NXDs may achieve these objectives both through their attendance at formal board meetings, but also through participation in one or more of the key board committees which, depending on the company, may include:-

- Audit
- Heath and Safety
- Remuneration
- Nomination

The Combined Code has further information regarding the briefing of NXDs as part of their recruitment process, details of the roles of the key committees and also a sample non-executive director appointment letter. This will have many of the same features as the proforma Chairman Appointment letter included in 5.1 above.

From a ShEx point of view, whilst the Chairman may often wish to lead the review and appointment process for NXDs, the team will still wish to ensure that:-

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- there is clarity on the specification for any new appointee with a view to establishing any key functional (e.g. former FD), technical (e.g. knowledge of nuclear) or personal qualities that the successful candidate should have;
- it is involved in forming the shortlist of candidates and the subsequent interview and selection process (i.e. sitting on the relevant selection panel)
- there is the right blend and mix of experience and skills on the board overall;
- ensuring that the NXD candidate(s) are appropriately briefed on key areas where ShEx has concerns or which form the key objectives of the board;
- there is an ongoing process of formal and informal communication between ShEx and the NXDs to ensure that ShEx fully understands the NXD's point of view and key concerns and that ShEx can, in turn pass on their own views.

NXDs performance should be reviewed as part of the wider board review process, as set out in section 6.6.

5.3. Board selection

The appendices for this section provide some useful aids that cover:

i. suggested core competencies that the ShEx might seek in a Chairman and CEO recruitment process;
ii. useful interview questions – aligned to the core competencies for the respective roles;
iii. a proforma specification for an FD core competencies.

Suggested core competencies for Cha | Competency based interviewing - sample | Outline FD specification.tr5

5.4. Recruitment processes

The process for appointments will vary depending on the nature of the business and the specific role. There are 3 sets of guidelines and/or regulations which ShEx must be aware of when making senior appointments:

i. Cabinet Office guidance
ii. The OCPA process
iii. The Civil Service Commissioners

Most ministerial appointments (i.e. those where Ministers make the ultimate decision on the appointment) must follow the process and guidance issued by the **Office of the Commissioner for Public Appointments, or OCPA**. The section below outlines more specifically the OCPA remit, as not all ministerial appointments are required to follow the process. For example Trading Funds are not 'public bodies' and therefore do not technically fall under the OCPA remit. However Cabinet Office has confirmed that the OCPA appointment process should be followed as a form of best practice.

Appointments and recruitment to the Civil Service are the responsibility of the Civil Service Commissioner who oversees the appointment of Senior Civil Servants. More detail is provided below.

The flowcharts in the appendices show the processes which are usually followed for Exec and Non-exec appointments for different types of businesses. However, it is

UKGI00044314

difficult to make any definitive classification as there are exceptions and peculiarities in most cases. The Articles of Association and/or associated legislation will normally detail what level of ministerial engagement is needed and so on.

i. Cabinet Office Guidance

The Cabinet Office provides guidance on 'Making and Managing Public Appointments':

http://www.cabinet-office.gsi.gov.uk/public/documents/pdf/public-appt_guide.pdf

This document provides detailed guidance on all stages of the recruitment and appointments process, and gives an overview of all the processes which may be involved in a public appointment (including OCPA & CSC).

ii. OCPA: The Office of the Commissioner for Public Appointments

The Office of the Commissioner for Public Appointments, or OCPA, supports the work of the Commissioner for Public Appointments, whose role is to regulate, monitor, report and advise on appointments made by UK Ministers & Welsh Assembly Government (Scotland & Northern Ireland have their own Commissioners who follow similar procedures).

The Commissioner's Code of Practice covers all ministerial appointments to the boards of executive and advisory non-departmental public bodies, NHS bodies, public corporations, nationalised industries, and utility regulators. The basic principle of the OCPA appointment process is that the position is openly competed, and that the process is transparent and fair.

Within the current ShEx portfolio the following businesses have certain roles which are ministerial appointments to which OCPA principles apply: Channel 4; British Waterways Board; Covent Garden Market Authority; BNFL; NDA; NLF; UKAEA; FSS; NIW Council. A full list of the appointments which must follow OCPA principles is available from the OCPA website: www.ocpa.gov.uk

The Commissioner has issued a detailed Code of Practice for government departments which defines and interprets the Commissioner's seven Principles of Public Appointments:

1. Ministerial responsibility
2. Merit
3. Independent scrutiny
4. Equal opportunities
5. Probity
6. Openness and transparency
7. Proportionality

Departments are allowed some flexibility in how they apply the Code of Practice but they must adhere to the principles. The full details of the OCPA Code of Practice are available here:

http://www.ocpa.gov.uk/upload/assets/www.ocpa.gov.uk/codeofpractice_aug05.pdf

Selection processes are monitored by OCPA in two ways:

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- **by independent scrutiny** during the selection process. No appointment can be made unless it has first been scrutinised by an Independent Assessor. These assessors are independent of the department. Their role is to act as the Commissioner's observer, to ensure that the selection process complies with the Code and Practice, and that candidates reaching the final stage are chosen on merit. In practice, the assessor does this by sitting as a member of the appropriate panel;

- **by annual audit**. Each year independent auditors visit a number of government departments and audit a sample of appointments. The audit round is arranged so that every government department is visited at least once every three years.

When commencing a ministerial appointment process ShEx is required to follow the principles set out in the OCPA Code of Practice. In addition to ensuring that the procedures used in advertising and selection for a public appointment follow the principles of open and fair competition, merit and probity, ShEx will also be required have an Independent Assessor during the selection process. OCPA maintain a central list of IAs who are available to use on request (see contact details on OCPA website).

The following flowchart outlines the OCPA appointment process.

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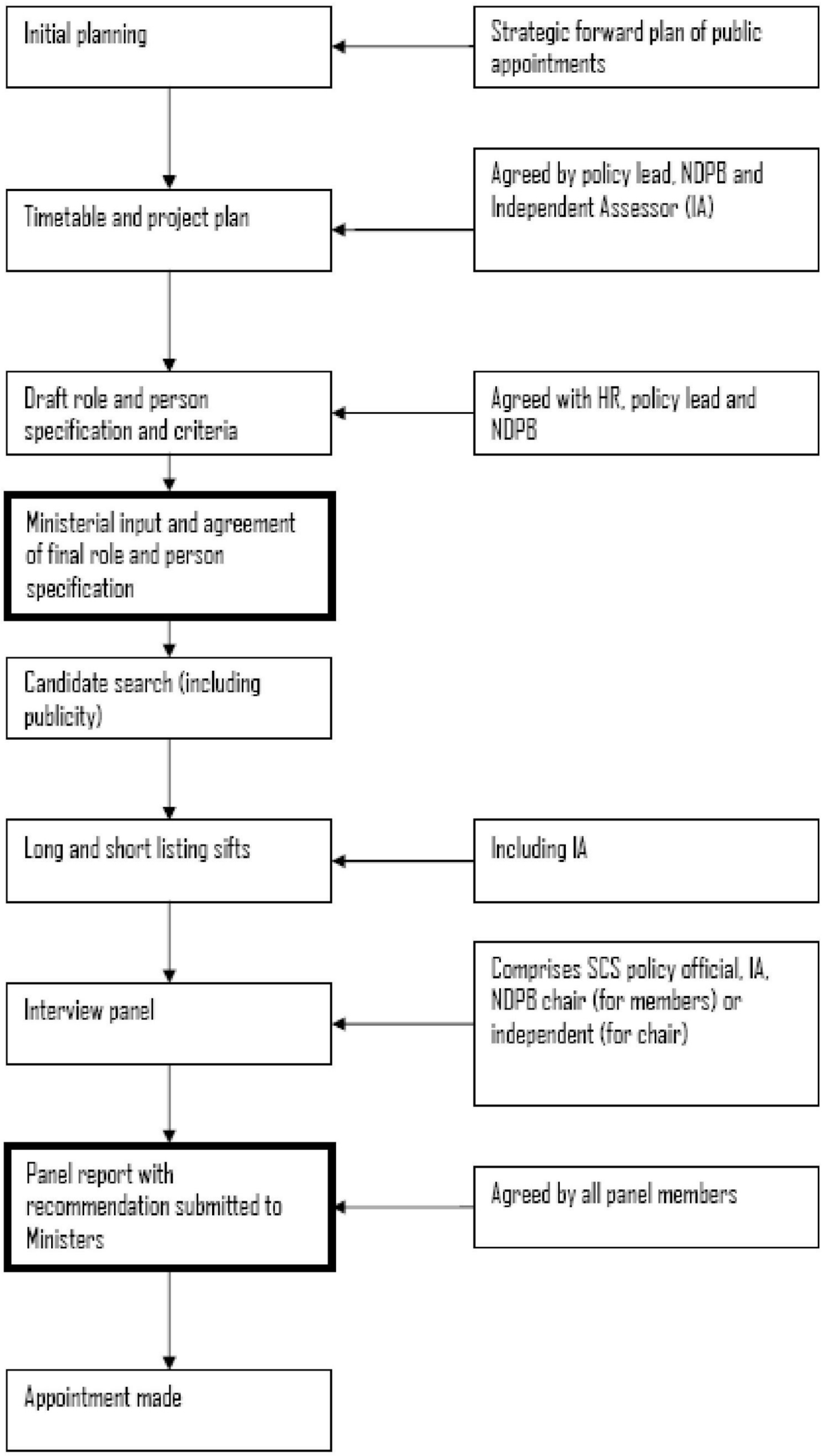
OCPA appointment process



(OCPA process from internal research report by ADP group, 2007)

UKGI00044314

iii. Civil Service Commissioners

The Civil Service Commissioners (CSC) are responsible for recruitment within the Civil Service, ensuring that appointments are made on merit. Their remit includes:

- issuing a Recruitment Code;
- ensuring compliance with the code;
- Chairing and overseeing the process for selection of senior civil servants;

The Commissioners are appointed directly by the Crown under Royal Prerogative. They are not civil servants and are independent of Ministers.

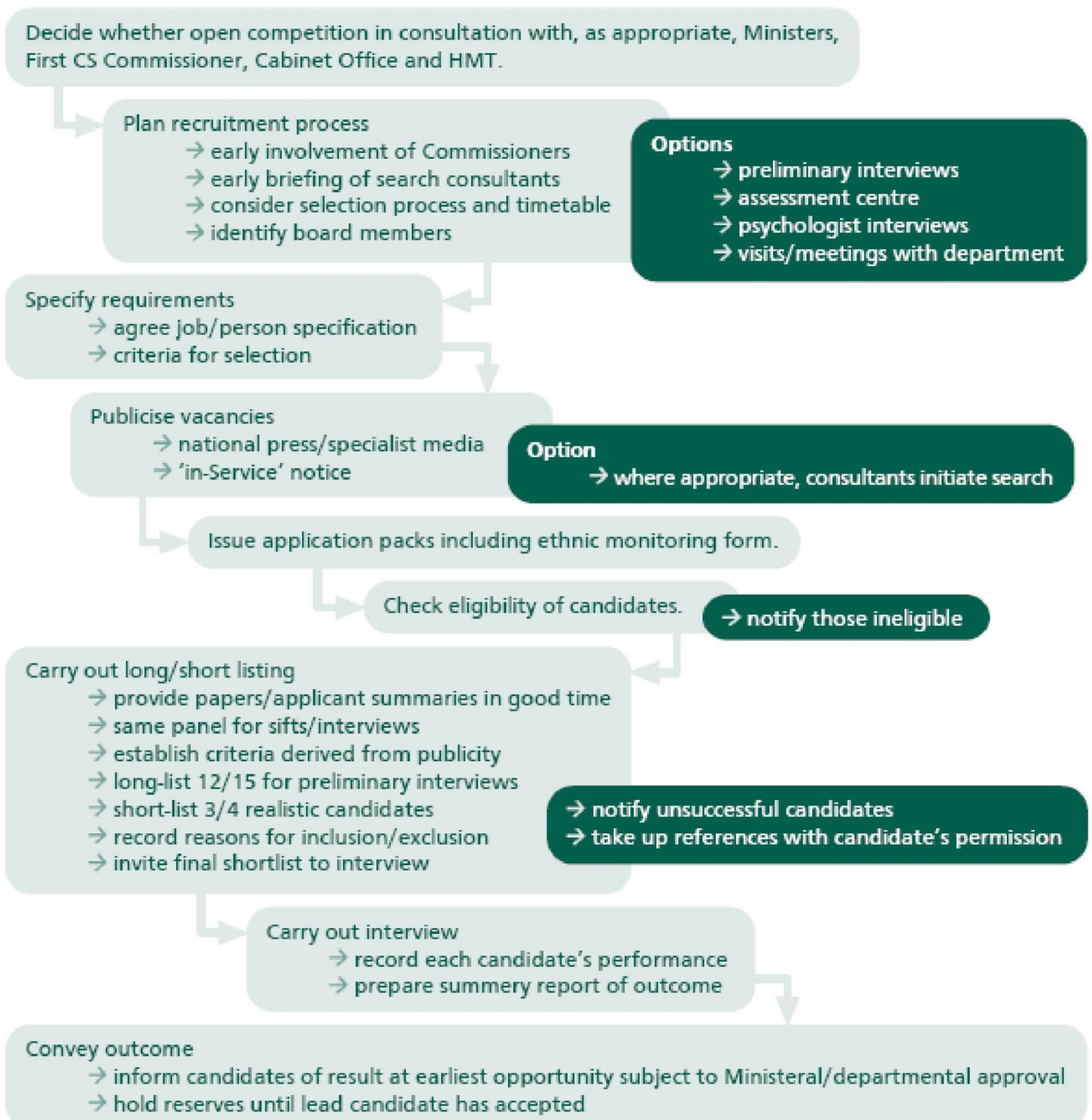
Approval of CSC is required for appointments for all top 200 posts within the Civil Service. This includes all posts at Pay Band 2 (or at least those that are external recruitments), Pay Band 3, DG, and Permanent Secretary levels. A Commissioner will Chair the process for selection for posts at these levels. Some examples of posts which are overseen by CSC are CEO of ShEx, Chief Executive of UKHO, and CEO of the Royal Mint.

The diagram below outlines the recruitment process, as envisaged by the Civil Service Commissioners: (Annual report 2006-07, http://www.cscannualreport.info/web-resources/resources/31d3ded0496.pdf).

More information is available on the website: www.civilservicecommissioners.gov.uk

UKGI00044314

Check list of Recruitment Procedures



5.5. Employing consultants (headhunters)

Executive search consultants are often used to facilitate a recruitment process. Consultants are used to conduct a search for a candidate, therefore they should be involved at the earliest possible stage. They should demonstrate a good knowledge of the nature of the role, and should ideally have experience of the relevant sector or market, as well as experience of public sector appointments where appropriate.

The Cabinet Office have a framework agreement or 'call-off' contract with a list of consultants which can be requested from their Corporate Development Group (the document is confidential). This is a list of consultants who can be contracted to provide recruitment advice and services without having to go through a full competitive tender process. However, it is good practice to approach a number of

UKGI00044314

companies to investigate their suitability for the particular process, and run a 'mini' or informal competition and ensure competitive pricing.

For some of ShEx businesses it will be the business themselves who are making the appointment and therefore contracting the services of the consultant. In these cases the normal Government procurement processes may not need to be followed and therefore consultants who are not on the Cabinet Office call-off list can be procured by the company. As public bodies, however, the rules will still apply to most of the businesses. Even where ShEx is making the appointment, it will still ask the business to fund the process, where possible, on the basis that the recruitment is, ultimately for the business' benefit.

The Management Incentivisation section that follows, includes more detail on the contract with Hay for remuneration advice which is linked to recruitment processes. In addition Appendix 2 of Section 5 (Exit Management and Advisory) provides more detail on the appointment processes for Consultants and Contractors, which is common to the recruitment advisers, as well as exit or corporate finance advisers.

6. BOARD REVIEW & EVALUATION

6.1. Introduction

A key part of the ShEx model is monitoring the performance of the business, including that of the Board and acting on any underperformance. The purpose of this note is to highlight when a review of Board performance should be undertaken, how it can completed and the areas that it should cover and then the actions and outcomes that might result.

As a minimum, this section refers to the formal review process that is undertaken by the Board of the company, either internally led by the Chairman or Company Secretary for example, of external by a specialist consultant and which forms part of Governance best practice, as identified in the Combined Code. There may also be other situations that prompt a one off Board review, that are also discussed.

In addition, ShEx will also be continually undertaking its own review of Board performance, both of the individual executive and non executive directors and their performance in their functional roles and the Board, collectively, and how they work together. ShEx will then incorporate their analysis and comment in the annual Investment Review or use as part of its routine assessment of the business and its performance and whether any changes need to be undertaken.

6.2. When to undertake a Board review

There are a number of different situations where a Board review may be appropriate:-

(a) *Pre-handover of business to ShEx*

- in order to assess strengths and weaknesses of team and their 'fit for purpose' versus ShEx view of key business tasks and objectives;
- looks for gaps in management team.

(b) *Formal annual review*

UKGI00044314

- part of 'normal' ShEx governance process e.g. included as a question in Investment Reviews;
- may be yearly or biennial;
- assessment versus standard benchmark (see appendix for extract from Combined Code;
- identifies Board's own view of its collective competence;
- more likely to be led by Chairman of business as an internal process, but ShEx should insist on a review the output.

(c) *Ad hoc review based on performance issues*

- will be typically used where there are underperformance issues, which, ultimately come down to management even where the stimulus might be external, such as sudden market change;
- will be focussed on key weaknesses and issues to be addressed and outputs may focus on management change of some sort – normally at Chairman, CEO or FD level.

(d) *Planning for change in business circumstances*

- looking at the question of do we have the right management team to take the business forward;
- is being proactive, rather than reactive;
- might be in response to clear challenges ahead such as a move from a Trading Fund to Govco to PPP status and assessing whether we have the right blend of skills to be successful in a fully commercial environment?
- Will often be expected or seen as a normal part of the process by private equity investors and hence completing prior to PPP may save time later in process and allow ShEx to address perceived management weaknesses before they impact on perceived value.

6.3. What should a Board review cover?

The following is a suggested list of areas that could be covered by the Board review and should be factored in when drafting a terms of reference involving and external, third party supplier such as an HR consultant. It is not a complete or definitive list, as each business will require a specific review. Consideration needs to be given whether the review covers both executive and non-executive directors and to what depth in the management team i.e. board level only or second tier as well. At the very least, the effectiveness of the working relationship between executive and non-executives will need to be incorporated.

The reviews may be extended to look at the effectiveness of individual sub-committees (e.g. audit, remcom, etc), as well as the Board overall.

i. Governance

Are appropriate board processes in place? Does the board meet regularly, with papers presented in a timely manner, minutes taken and decisions recorded?

Does the board receive an accurate and timely supply of financial and other information appropriate to the needs of the business and presented in a format that allows effective decisions to be made?

UKGI00044314

Are the matters reserved for board review/decision clearly set out and does the board keep to those areas?

Has the board established an appropriate set of sub-committees covering, for example, audit, remuneration, health and safety?

ii. Board Effectiveness

Does the board set the strategy /long/medium term direction of the business and does it monitor progress against a defined and measurable set of objectives?

Is there evidence that the board has/is able to take effective action to remedy underperformance or react to external opportunities/threats?

Is the interaction between executive and non executives directors effective? Do the NXDs challenge the executive in a robust but constructive way?

iii. Board Competence

Do the directors have the correct skills and competences to carry out their duties? This may require that a skills review mapped over the business plan requirements be produced.

Are there any significant gaps in board competence? If so has the Chairman identified the gaps and are steps in place to remedy them?

Do the non-executive directors review the material sent to them and are they able to contribute effectively to decision making?

Do the non executive directors have a sufficient grasp of the detail of the business and the issues facing it to allow them to contribute effectively, appropriate to their level of responsibility?

iv. Stakeholder representation

Do the chairman/non-executive directors/board members have a clear understanding of the shareholders/stakeholders requirements?

Does the board act to maximise shareholder value/in accordance with agreed shareholder priorities?

Do they communicate effectively with shareholders/stakeholders?

Does the shareholder(s) communicate effectively with the chairman/board? Have clear, measurable targets and priorities been set for the board by shareholders/stakeholders and does the board report progress against those targets?

UKGI00044314

6.4. Appointing External Consultants

Appendix X provides a proforma tendering letter to use with prospective advisers and consultants, when seeking external input to a Board review.

Proforma Instruction letter for External Bo

The appendices include some introductory comments from Egon Zehnder and ER consultants re their approach to board reviews, the former in a private equity capacity. Neither of these consultants are, necessarily, recommended to undertake work for the ShEx, but provide illustrations of approach and some considerations to be factored into a board review process.

ER Consultants briefing note re Boarc

Egon Zehnder Management Apprais

Board Review - Summary

A board review is part of the due diligence process that ShEx can use as a tool when reviewing a business, in the same way that an accounting or market due diligence exercise by external consultants can be used to review those specific assets of the business.
In addition to using it at specific times, such as when portfolio problems occur, it should also be seen as part of good governance, as recommended in the Combined Code, where the review may be more of an internal led process led by the Chairman.

6.5. CHANGING MEMBERS OF THE BOARD

As part of its ‘Action on Underperformance’ (see section [xx]), ShEx will potentially seek a change in management of one of the portfolio in order to improve performance. There are, however, also process considerations in removing/changing directors, both non executive and executive.

This is an important area for the following reasons:-

(a) there may be legal issues that might be relevant to ShEx and the portfolio business to ensure that any threat of unfair dismissal or a legal claim for compensation from the employee is mitigated;

(b) there may be reputational issues and ShEx will wish to be seen as fair, as well as commercial, in protecting the best interests of the shareholder, in order to avoid negative PR and the incremental work associated with management change that is poorly managed.

To achieve these objectives, ShEx will use the following processes when involved in management change:-

(i) ShEx will ensure that there are clear business objectives that the management know it is trying to achieve and this will then be translated to individual management objectives for the key team members, notably the Chairman, CEO, FD and Non Executives. Reputational and legal issues are likely to be avoided if ShEx and/or the person leading the

UKGI00044314

management change (e.g. the Chairman for the CEO) is able to performance management against agreed objectives;

(ii) Ensure that there is regular feedback to the relevant individual. Ideally, a move to change a director should not come as a surprise, but be the culmination of a consistent feedback re performance that needs to be acted on;

(iii) If there is a need for management change, where possible ShEx will seek to work through the Chairman, rather than get involved in the change of executive management change directly.

(iv) Prior to acting on the management change, ShEx will ensure that legal advice has been taken to ensure that:-

   a. There is a full understanding of the contractual position of the relevant individual;
   b. That any relevant labour legislation has been taken into consideration.

   In so doing ShEx will ensure the business' legal and reputational position, as well as that of its own, is protected.

Note

It should be noted that, particularly in relation to the Chairman and NEDs, both OCPA and the Combined Code comment on the need to regularly refresh the Board as an objective in its own right. This has merits in bringing in fresh perspectives and challenge to the Board and also breaking up any 'cosy' relationships between the executive and non executive directors. However, such change, for change sake, may also be inappropriate where the Board is working well and where ShEx is extremely happy with the relevant Directors and the overall performance of the business.

The OCPA and the Combined Code assumption and recommendation is that Directors serve two-three year terms, with the presumption that a new appointment is then made to refresh the Board. However, in exceptional circumstances, ShEx may seek to argue that, notwithstanding the recommendations of OCPA, that in fact no change may be necessary or warranted. In this situation ShEx can lead a renewal process where a competition does take place for a new appointee, as per OCPA guidelines, but where the current appointee is one of the candidates despite having already fulfilled 2 term appointment. ShEx will need to argue the merits of the case appropriately.

UKGI00044314

SUMMARY OF APPENDICES TO SECTION 3, PART 5 : CORPORATE GOVERNANCE

Proforma outline Governance letter or Framework Document

Example: UKAEA Chairman letter

Example: Royal Mint Chairman letter

Example: Royal Mint ShEx Delegated Remit letter

Example: Actis Shareholder Relationship letter

Proforma Chairman Appointment letter

Example: Scottish Water Chairman letter

Non-Executive Director assessment checklist (performance evaluation)

Chairman/CEO suggested Core Competencies

Competency based interviewing sample questions for Chairman

Competency based interviewing sample questions for CEOs

Proforma FD role specification

Extract from Combined Code: Performance Evaluation guidance

Proforma instruction letter for external Board Review

ER Consultants briefing note on Board Evaluation & Development

Egon Zehnder Management Appraisal private equity users' guide

Additional appendices provided separately

Example: DSTL Framework document

Flowchart: Processes for approving Exec and Non-exec appointments