2019 CORPORATE and COMMERCIAL LAW CONFERENCE

The future of the corporation – A perspective from the Boardroom

29 October 2019

Introduction

Corporations play a vital role in allocating capital efficiently, delivering gains in productivity and creating value. Companies, large and small, now compete globally for customers, capital and talent, and they must manage risk flexibly and dynamically if they are to remain financially viable and preserve shareholders' invested capital or equity.

However, the scale, global reach, social and environmental impact of corporations has led to an expectation, including in Australia, that their directors should consider a broader set of stakeholders.

In considering this question, I will examine the issues raised by Professor Mayer and the British Academy's research in the four focus areas identified, being: Law and regulation; Ownership and governance, Measurement and performance and Finance and investment.

I will then make some concluding observations.

My comments will necessarily draw on personal experience, and include certain inferences from the particular to the general, but this is not inconsistent with the approach taken by the Academy.

Law and regulation

The framework relevant to this question in Australia is Section 181 of the Corporations Act which requires that directors of a corporation exercise their powers and discharge their duties:

(a) in good faith in the best interests of the corporation; and

(b) for a proper purpose.

The question as to whether these provisions of the Act need to be made more prescriptive through legislative change has not gone unasked.

Notable inquiries include:

- An inquiry by the Parliamentary Joint Committee on Corporations and Financial Services, into corporate responsibility in 2005, and
- A second inquiry, by the Corporations and Market Advisory Committee on the same topic, the following year.

Both reviews concluded that the law, as it is was written, should be maintained.

Even at its narrowest interpretation, where the interests of the corporation could be equated with the interests of shareholders, a director must consider: which shareholder? The high frequency trader who is on the

register for a fraction of a second? The retail shareholder who has held their shares since the wave of privatisations in the 1980s and '90s in Australia and simply wants to know whether the dividends are secure? The global fund manager who keeps asking you to explain Australian politics? The Superannuation Fund in pension mode, or the one in accumulation mode? Or the institutional investor who, helpfully, lends their holding of your shares to a hedge fund, which then proceeds to short your stock?

Directors must, therefore, often work with the concept of a 'hypothetical' shareholder when considering the best interests of the corporation, and this construct enables a broader group of stakeholders to be considered.

This is further underpinned by the perspective that shareholder interests will align in many key respects, and over time, with those of other stakeholder groups.

In practice, the current formulation of directors' duties in the Act enables directors to respond to a changing environment and shifting community attitudes, and to consider other stakeholders when meeting their obligations to act in the best interests of the corporation.

The specific stakeholder groups have progressed from a focus on employees and customers, (recognising that disaffected employees lead to disaffected

customers and thereby detriment to the business), to a broader consideration of the local community, the environment, society more generally and, in some cases, to the national interest.

It is likely that a corporation will have an impact on one or more of these groups, creating what economists define as externalities: costs or benefits of an economic activity experienced by an unrelated third party, where the external cost or benefit is not reflected in the final cost or benefit of a good or service.

Failing to consider the adverse externalities arising from a corporation's activities can have serious implications for reputation and will ultimately undermine trust. A loss of trust is the costliest damage a corporation can sustain, and directly impacts shareholder value. In a sense, therefore, the need to consider a broader group of stakeholders when acting in the best interests of the corporation, becomes a self-reinforcing dynamic.

In this context, the negative reaction of the Council of Institutional Investors to the US Business Roundtable's Statement on the Purpose of a Corporation, including the fact of shareholders being placed last, is surprising: it is hard to see how delivering value to customers, investing in employees, dealing fairly and ethically with suppliers, supporting

communities and protecting the environment is in any way inconsistent with generating long term value for shareholders. In fact, they are very necessary precursors, so there is logic in shareholder value being the final element of the commitments list. The subtext of the Business Roundtable Statement is perhaps relevant, given the rise of populism in the US, and inequality being cast into relief by the lack of positive spill over from the successes of the tech companies in particular; in fact the reverse is true: not only are the profits concentrated in the hands of a few, but the cost of housing in places like San Francisco and Seattle is disadvantaging the many.

This is not to suggest that the interests of shareholders and other stakeholders are always fully aligned. This would be a dramatic simplification. But nor, as a director, do I agree with the statement that "Currently conceived, the purpose of business is straightforward: to promote the interests, wellbeing and wealth of their owners - their shareholders", Milton Friedman notwithstanding.

Deliberation, judgement and balanced decisions are required; this is core to the role of a director and is enabled by the law which points to acting in the best interests of the corporation.

The framework guiding this deliberation and judgement has evolved over time: the Memorandum of Association for a corporation used to include an Objects clause, and the company could not perform any actions outside of, or inconsistent with, its Objects.

We have moved beyond a dry Objects statement, and, aided by Strategy consultants and Business Management literature, have traversed the landscape of Vision and Mission statements – the distinction between which has always eluded me – and now recognised the importance of corporations having a clear Statement of Purpose.

Such statements have been used by corporations in Australia for some time, and increasingly reference stakeholders other than shareholders. For example,

- CBA's stated Purpose is to improve the financial wellbeing of its customers and communities;
- Worley's is to help its customers meet the world's changing energy, chemicals and resources needs.

The role of a corporation's Purpose Statement is twofold:

- From an internal perspective, it guides the evolution of strategy, priorities and decision making, a dimension I will return to when I comment on *Ownership and Governance.*
- Externally, it sends a signal as to the intent, nature and commitment of a corporation. This aspect was referenced by Blackrock's Larry Fink when he wrote to the fund's investee companies in January last year,

putting them on notice that his fund would from then on pay attention to their stated purpose, not just their returns.

Over the past 60 years, there has been much academic research into the impact of Mission or Purpose Statements, including a finding by American academic John Mullane, who, in 2002, concluded that it was not the contents of the statement that was most relevant in terms of outcomes, but rather the process used to prepare it, and how the finished document was employed in the organisation.

The British Academy's endorsement of the importance of a corporation's Purpose, and of holding corporations, and their directors, to account for delivering that purpose, is very appropriate; the proposition that it be regulated by law is, however, problematical, not least because the laudable higher intent will very quickly morph into a practical contest with unintended consequences:

- how much time will be consumed in crafting the purpose to the exclusion of other deliberations
- will institutional shareholders react to the literal words of a such a statement and demand by law that their interests have primacy;
- will directors feel constrained from taking difficult decisions, for fear of straying from their now legally defined purpose.
- will Purpose Statements tend towards the generic, in an attempt not to be a constraint on boards and management making legitimate

decisions. In this scenario the concept of a 'Purpose' would be undermined, whether as an heuristic tool or as legal inducement.

- A rigid interpretation would also, I suspect, lead to a shift away from the corporate structure as a preferred vehicle for capital.
- And, with all due respect to present company, the scope for class actions for Breach of Purpose doesn't bear contemplating, given the prevalence of class actions in Australia.

Clearly, the legal framework must continue to evolve to ensure it is meeting the expectations of society, but care should be taken not to impede the ability of directors to think independently and critically about the challenges faced by the corporation.

The increasingly rapid cycle time of innovation in business models can require a corporation to evolve its purpose over a relatively short period. When I joined the Telstra Board in 2000, its purpose would have been described as providing advanced telephony, because voice calls were its predominant source of revenue; within a decade, the business model had changed fundamentally from voice over copper to one based on data over fibre. Telstra's purpose now is: 'To create a brilliant connected future for everyone', with connectivity being a central concept.

Ownership and governance

As is well known, last year, APRA conducted a Prudential Inquiry into Culture, Governance and Accountability at CBA. Both ASIC and APRA have subsequently undertaken reviews on these aspects across the financial services sector and more broadly.

As we have said publicly, on many occasions, these reviews have been helpful, not least because they have caused us to sharpen our understanding of exactly what we mean when we refer Culture and Governance. Definitions matter, and unfortunately both terms have been used loosely, if not glibly, by many commentators.

First to Governance, and drawing on the OECD definition: Corporate governance involves a set of relationships between a company's management, its board, its shareholders and other stakeholders. It provides the structure through which the objectives of the company are set, and by which the means of attaining those objectives and monitoring performance, are determined.

The three vectors of governance are therefore *Direction*, *Control*, and *People,* and at CBA we have identified, for each vector, the key frameworks through which the Board exercises its governance role.

- *Direction* is achieved through the frameworks of our Purpose together with the strategic plan congruent with that purpose, as well as frameworks which provide engagement with, and understanding of, the external environment.
- *Control*, as in a state of control, is achieved through many frameworks including the business plan, the risk management and policies framework, the customer complaints framework, the management and financial reporting framework and so on.
- Similarly, the *People* vector is governed through the frameworks governing values, remuneration, work health and safety, and training.

Now to Culture. Culture has two dimensions: the human and the infrastructure. The latter comprises the policies, processes and systems which drive the core functions. Here the objective is discipline, consistency and repeatability; the environment is predictable.

The human side relates to unpredictable situations where the key capability is judgement. It is here that the Values of an organisation are important. Values are not about right and wrong: there is no place for people who do not understand the difference, or who do, and are just unethical. Values are about preferences and priorities, and guide decisions and judgements in circumstances where the answer is not clear.

At CBA the bridge between the two sides of culture is provided by the Code of Conduct. The Code starts with our Purpose, describes our Values, clarifies how to escalate concerns, and then links to the infrastructure dimension by identifying the core policies with which every employee must be familiar.

Given this approach to governance and culture it is possible to demonstrate how the British Academy's Corporate Governance Principle of alignment of interests can be achieved– but only if there is agreement on the definitions of governance and culture, and a preparedness to engage in the granularity of implementation. The detail really matters.

I would argue that our focus should be on the substantive detail of the governance and culture frameworks in a corporation. Purpose is one element, an essential element, but it does not define overall governance.

On the question of ownership, and shareholders support for the corporation's purpose, I can attest to the Academy's view that institutional shareholders have moved to adopting 'enlightened shareholder capitalism'.

If I look back ten years to when I first came into a Public Company Chairman role, my meetings with institutional investors were led by the investment analyst team, and the ESG team –usually a team of just one very junior person– might have been invited in as an afterthought. Now, the ESG team

of experienced experts often takes the lead and, importantly, holds the Proxy voting pen.

In June I attended the Annual Global Governance Conference convened by the ESG teams of all the major global investors, with Chairmen and Lead Independent Directors attending by invitation. In previous years the focus of the conference had been on corporations' environment and climate policies. This year there was a clear message that the ESG teams and proxy advisors will now start to hold corporations to account, through the exercise of their AGM voting rights, for the effectiveness of policies on employees and workforce transitions in the face of automation.

Measurement and performance

On measurement and performance, the Academy's paper advocates the use of non-financial measures of performance, both for the corporation and its management.

For corporations, it is undoubtedly the case that there are metrics beyond the financial accounts which help to characterise the full extent of the firm's activities. There have been many attempts to develop frameworks for this: concepts such as triple bottom line accounting, integrated reporting, and corporate social responsibility metrics have been variously adopted. It

would be helpful if, as the Academy suggests, a degree of standardisation could be achieved, though it will be challenging.

There is also a risk of what ASIC has recently called ‘Sludge’; that is, so much disclosure as to be overwhelming. CBA’s 2019 Annual Report, with over 300 pages, all verified, assured or audited as appropriate, attempted to combine discussion on delivery of our purpose, a detailed review of operations, full TCFD reporting on our climate policy, comprehensive ESG metrics and user-friendly financial statements. Feedback has been positive, but I suspect we have reached a practical limit for both preparers and readers.

Turning to the use of non-financial measures for management performance, and hence remuneration.

Some may recall that CBA incurred a first strike at our 2016 AGM, triggered by the expansion of non-financial measures in the Long Term Remuneration Plan. Our response was <u>not</u> to abandon the principle that such measures are important, but rather to think more carefully about what we were trying to achieve. This led to a fundamental redesign of the measures, resulting in a focus on Trust and Reputation, and Employee Engagement.

Our philosophy was that these are pivotal lead indicators of long-term value creation, in contrast to financial measures which are lag indicators, and both have a place. Shareholders have endorsed our approach, with Remuneration Report votes in favour exceeding 90% in the three years since our redesign.

The question of the role of non-financial measures in Remuneration Frameworks was canvassed in the Banking Royal Commission and is now the subject of consultation following the release of APRA's draft CPS 511 standard.

Finance and investment

Turning to finance and investment. In this context it is crucial to recognise that corporations compete for capital. As I alluded to earlier, given the disparate nature of shareholders, not all capital comes with the same objectives.

At their core, modern capital markets are premised on the dynamics of risk and return. Those who provide capital, including ethical investors, expect those who manage that capital to take controlled risks and to generate returns.

In collaboration with Yale University, European asset manager, NN Investment Partners, which manages over € 240bn, recently surveyed over 200 fund managers across Europe and found that investors were willing to sacrifice returns to support ESG or responsible investing goals, up to a point: investors said they were prepared to forgo up to 2.4% a year if it meant investments had a positive non-financial impact. The corollary of this preparedness is the expectation that there would be enough profitability to absorb the return forgone, and still be in positive return territory.

Are there ways that the current framework for finance could be refashioned to enable more long-term decision-making by directors and management? Certainly, but it will likely manifest by capital moving to the private market. The shorter-term focus of the public capital markets is unrelenting, notwithstanding the equally unrelenting calls from directors for shareholders to focus on the long term.

Areas for further consideration

To conclude I would make a few observations.

The definition of the overarching corporate purpose as being 'to produce profitable solutions to the problems of people and the planet' is at once limiting, and too expansive.

Corporations deploy intellectual, physical, intangible and financial capital; they manage the complexity and risk of that deployment through a business model which involves compliance with multiple regulatory frameworks; and successful corporations will remain viable over time only by innovating at both the product and business model level, and increasingly by incorporating full sustainability principles. With rapidly evolving technologies, this requires sophisticated supply chains, partnerships and collaboration. It used to be the case that we worried about <u>third</u> party risk; we now must consider <u>fourth</u>- and <u>fifth</u> parties.

If I consider the large corporations on whose Boards I have served:

- Telstra, now enables 65 million voice calls every day, and more than 33 petabytes of data sent and received; we have gone from 3G to 5G mobile technology in just over 10 years, requiring $billions of investments across the sector;
- At CommBank, the payments platform enables 22 billion payments annually, or 41,000 every minute, with planned investment in systems of $5bn over the coming years;
- Worley is working with customers in a global energy system which is grappling at the most fundamental level with how much of our energy needs will come from molecules and how much from electrons, and how both can be generated sustainably.
- Australia's energy companies are operating in one of the largest interconnected power systems in the world, including 1.7million solar

PV units, which is a 120-fold increase in these units over the past 10 years.

Those corporations which are contributing solutions to the world's problems are doing so as part of an integrated system, any element of which is vulnerable, and within which the degree of interdependence in is escalating. Corporations in key sectors are carrying a significant part of the adaptation load for the economy and the community, and the next decade will be critical.

So rather than adding to the regulatory challenge by regulating the Purpose Statements of corporations, we – corporations and regulators - should be seeking to evolve the regulatory engagement model itself, to be increasingly real time, interactive and verbal, so that issues can be addressed expeditiously, and emerging problems anticipated. This would help to reduce the "regulatory lag" of which Professor Mayer spoke.

The third player in this mix is government: corporations operate within given policy frameworks. They can seek to influence policy, but they cannot make policy. To the extent that their performance should reflect externalities, whether positive or negative, the most efficient way for this to be done transparently, and with comparability, is for a government determined valuation framework. Governments are best placed to prevent a Tragedy of the Commons.

The design tolerances of the corporation construct will be exceeded if it is expected to be the primary solution vehicle.

It is certainly essential to take individual corporations to task, but the key is having government, regulators and corporations aligned, to ensure that the primary source of our prosperity, capitalism, can continue to solve problems, create that prosperity and operate within an ethical framework that delivers for all stakeholders.

As to the very legitimate concern raised by the Academy regarding potential detriment from technological advances, particularly artificial intelligence and genetic engineering: these advances are emanating from universities and research institutes, are being adopted and progressed by many organisations, including corporations, and embraced by the community, governments, and law enforcement authorities.

What has been lacking is a whole of system view of their implications and unintended consequences – and a policy framework to manage them. We have been slow to understand the characteristics of data as an individual and a national asset; we have been slow to recognise the implications of global platform business models. I only hope we are in time to consider the implications of crypto currencies at global scale.

There are now myriad attempts to address this failure, including for example, a seminal initiative by Tristan Harris in Silicon Valley who has established the Centre for Humane Technology; in Australia the Federal government has funded the development of an ethical framework for the application of AI; and at the University of Technology Sydney, where I am Chancellor, we have specifically adopted, in our Strategic Plan, a commitment to the Responsible Application of Technology. And interestingly last week the Joint Parliamentary Committee on Intelligence and Security rejected proposed legislation for Identity Matching Services which would have resulted in a widely accessible national biometrics database.

If we are facing the prospect of technological singularity, as the Academy fears, I fear that purpose-led corporations alone will be no defence.

Catherine Livingstone

29 October 2019