SUPREME COURT OF NEW SOUTH WALES

ANNUAL CORPORATE LAW CONFERENCE

What is the Future of the Australian Business Corporation?

2019 Conference

Tuesday, 29 October 2019 at 1.35pm

Banco Court, Supreme Court of New South Wales,
Level 13, Queen's Square, Sydney

HER EXCELLENCY, THE GOVERNOR OF NEW SOUTH WALES:

Dr Austin, distinguished guests ,ladies and gentlemen, it gives me great pleasure to introduce Professor Colin Mayer, the Peter Moores Professor of Management Studies at the Said Business School at the University of Oxford.

The Said Business School provides a transformational experience led by and producing scholars with transformational ideas. It is therefore fitting today that Professor Mayer is the first speaker at today's conference.

Professor Mayer was the first professor at the Said Business School, commencing in 1994. He became the Peter Moores Dean of the Business School between 2006 and 2011, and the first Director of the Oxford Financial Research Centre between 1998 and 2005. He has been a Harkness Fellow at Harvard, a Houblon-Norman Fellow at the Bank of England, the first Leo Goldschmidt Visiting Professor of Corporate Governance at the Solvay Business School, and has had esteemed visiting positions at Columbia, MIT and Stanford, amongst other things that he has done, and he currently leads the British Academy, as the Chief Justice has indicated.

He is the author of "Firm Commitment: Why the corporation is failing us and how to restore trust in it" and "Prosperity: Better business makes the better good".

Professor Mayer's work and that of the Said Business School featured in the Financial Times in August of this year when the Financial Times reported and drew attention to the fact that the Said Business School was calling for business to reorient back to its historic roots, operating to profitably meet the needs of society rather than of shareholders. The theme or the thesis of that report was that business schools must support firms and their leaders to discern their purpose in the world and to act accordingly.

I think, therefore, as the first speaker, we have a very interesting launch of today's conference. Thank you, Professor Mayer.

PROFESSOR MAYER: Your Excellency, Chief Justice, honourable ladies and gentlemen, it is a very great pleasure to be here. Thank you very much for your introduction.

I am going to be talking to you about one of the most important institutions in our lives. It is not the State, religion, or indeed even the Supreme Court. It is an institution that clothes, feeds and houses us, that employs us and invests our savings. It is the source of economic prosperity and the growth of nations around the world.

At the same time, it has been a cause of growing inequality, environmental degradation and mistrust.

Every year for the past 35 years, Ipsos MORI, the market research company, has undertaken a survey of 1000 people in Britain as to which professions they trust to tell the truth. At the top, alongside doctors, nurses and teachers, I am pleased to say come university professors. We might not have much power, pay or prestige, but at least people trust us to do nothing, earn nothing and take no credit for it.

At the other end come business leaders, just ahead of estate agents, professional footballers, journalists, and rock bottom come politicians. They come below bankers and the man and woman in the street. This has been a feature of the survey every year since 1983 when it first started. Mistrust in business is profound, pervasive and persistent.

Why is that the case? I would suggest to you that the reason is what is sometimes termed "the Friedman doctrine", after Milton Friedman, the Nobel Prize winning economist, who said that there is one and only one social purpose of business, to increase profits so long as it stays within the rules of the game. That has been the basis of the growing levels of mistrust of business to which I have just referred. It has been the basis of business practice, business policy and business education ever since.

But it wasn't always the case. The corporation was established under Roman law to undertake a very public function, of collecting taxes, minting coins and maintaining public buildings. For nearly all of its 2000-year history, it has combined its normal commercial activities with a public role.

The notion that there is only one purpose of business, to make money, is something that has grown progressively, in particular over the last 60 years since Milton Friedman put forward his proposition.

It is likely to become a more serious issue, because as technology accelerates, it not only offers tremendous opportunities for enhancing human wellbeing, but it also poses serious risks, and as technology accelerates, the lag of regulatory responses behind business innovation increases. For example, in relation to artificial intelligence, it is not simply that that is going to have a profound impact on manual labour; it will have an even more significant impact on mental labour as machine learning accelerates and machines are able not only to assist us in making decisions, but take decisions for us, not least in the boardrooms of companies. That raises very profound questions about the algorithms that lie behind those machines and the purpose for which they are programmed.

Now, this is a subject that is rapidly changing. At the beginning of this year, Larry Fink, the CEO and president of the largest investment management business in the world, BlackRock, said that every business needs a purpose, not a strapline or a marketing campaign, but a statement of its fundamental reason for being. Purpose, he said, is not the sole pursuit of profits but the animating force for achieving them.

As the Chief Justice just mentioned, in August of this year the Business Roundtable discarded its 1997 statement about shareholder primacy in favour of a statement of corporate purpose, in which it said that corporate purpose is about delivering value for customers, investing in employees, dealing fairly with suppliers, supporting community, sustaining the environment and creating long-term value for shareholders. Last month the Financial Times launched its largest campaign since the financial crisis under the heading, "Capitalism: Time for a reset". The editor, Lionel Barber, wrote to all of its readers saying that the health of free enterprise capitalism depends on business delivering profits with purpose. Without change, he said, the prescription will be much more painful.

Now, all of this reflects a growing interest and concern about the reason why business exists, why it is created, what it is there to do and what it aspires to become - namely, the purpose of business. Everything - business practice, policy and education - follows from that.

The purpose of business is not just to produce profits. The purpose of business is to produce profitable solutions for the problems of people and planet. In the process it produces profits, but profits are not, per se, the purpose of business. Everyone who runs successful businesses knows that to be the case, and they don't profit from producing problems for people or planet. Instead, what they do is they commit to a corporate purpose, and they commit to those who help to create that corporate purpose, and those people, in turn, help to commit to the creation of a corporate purpose.

That gives rise to reciprocal relations of trust and mutual benefits, both for the parties to the firm and for the firm itself. It creates more loyal customers, more engaged employees, more reliable suppliers, more supportive shareholders and societies. That is associated with greater revenues, lower costs and more profits.

Now, underpinning this is the trustworthiness of business to promote those purposes and the ability of companies to be able to commit to those purposes. Underpinning that are the values and cultures of business: values of commitment to corporate purposes and cultures of honesty and integrity in so doing.

To address one of the issues that the Chief Justice raised about the nature of purpose, let me just be clear that a corporate purpose is neither just descriptive of what a company does nor aspirational in terms of saving the world. A corporate purpose is precise about what problems it is there to solve, whose problems, how it is going to solve those problems, when it is going to solve them and why the company is particularly well suited to solving those problems.

I want to illustrate this in relation to one example of a pharmaceutical company, a very large producer of insulin. It is a Danish company called Novo Nordisk. A few years ago it realised that it was failing in delivering its product to those people who were, in many respects, most in need of it. Insulin is used for treating type 2 diabetes, and 85 per cent of the world's type 2 diabetes is found in low- and middle-income countries, many of which could not afford to purchase its insulin. So what it initially did was to cross-subsidise the price at which it sold insulin in developing countries from the profits it was making in developed countries. That was quite interesting, but not profound.

What it then realised was that its purpose was not simply to produce insulin, its purpose was to treat people who had type 2 diabetes. So it started working with medical practitioners, doctors, nurses and universities around the world to identify the best way of treating type 2 diabetes, which might involve taking insulin but in many cases did not.

And then it realised, well, actually, its purpose wasn't simply to treat people who had type 2 diabetes either. Its purpose was to help prevent people from getting type 2 diabetes at all; and its purpose is now to eradicate type 2 diabetes around the world.

So it then started to work with health workers, with local governments, with national governments, to identify the changes in lifestyles of individuals which would help them to avoid getting type 2 diabetes.

Now, you might say, "Well, that's all very well and very worthy, but doesn't it undermine the fundamental model of Novo Nordisk?" The answer is no, it did exactly the opposite, because in the process of building up those relationships with health practitioners, workers, governments and local authorities it became a trusted supplier, and so its business has boomed on the back of those relations of trust that it has built up with many parties around the world.

Now, mention has been made of the fact that the British Academy is undertaking a major program of research on the subject of the future of the corporation to address the economic, social, political and environmental challenges it faces, as well as to take advantage of the technological and scientific advances that are in progress. Quite deliberately, the title is, "The Future of the Corporation", not "business", to address precisely one of the issues that the Chief Justice raised about the nature of business where this is a particularly important issue, and that is in relation, indeed, to the largest corporations around the world. Because of the nature of those businesses, they have the ability and the power to influence our lives most significantly.

What The Future of the Corporation program did was to identify a way in which we might think about reconceptualising those businesses in such a way that they perform somewhat more effectively in what we, as individuals and societies around the world, need of them.

That reconceptualisation was exactly around those three areas that I have just mentioned: the purpose of business, why it exists and what it is there to do; its trustworthiness to do that; and its values and cultures to achieve that.

It has now, this year, gone on to set out four sets of policies around which reform can, we would argue, effectively take place. The first of those is, indeed, on law and regulation. Law at the moment is predominantly focused on the responsibilities and duties of directors of companies to promoting the interests of their shareholders. Important though that is, that is not the primary function that the directors of companies should be focused on. Their focus should be on the purposes of their businesses, identifying their purposes and demonstrating that the constitutions of their companies are aligned with the effective delivery of those purposes.

Regulation is predominantly viewed as being in regard to the rules of the game and the enforcement of the rules of the game. Again, that is very important, but it is not adequate in many circumstances, as we observe from the repeated failure of regulation to achieve the desired social outcomes in many industries, in many countries around the world.

That reflects a failure to align the purposes and objectives of companies with their objectives under regulation and the conflicts that arise as a consequence of that.

So the element of regulation that we regard as being critically important in that regard is to align the purposes of companies that do perform particularly important public functions, namely, the commanding heights of the economy - the utilities, the banks, the auditing companies, public service providers, infrastructure companies, regulated companies in general - where there is a need to have an alignment between the private and public objectives of companies.

There are ways in which those types of approaches have been adopted. In particular, what is termed the Public Benefit Corporation in the United States has been set up to allow companies to incorporate with a public purpose alongside the requirements on the directors of those companies to promote their commercial performance.

That has a particular relevance in the circumstance in which it is necessary to potentially align private and public purposes of companies in regard to those commanding heights of the economy to which I just referred.

The second area in which we have focused our attention is in relation to the ownership and governance of companies. Ownership of companies is predominantly viewed in terms of the rights of shareholders. Again, important though those are, so too, and increasingly so, are the responsibilities and duties of shareholders in helping to define the purposes and to achieve the implementation of those purposes.

Those objectives are undertaken effectively in many forms of ownership that one observes around the world, in particular in the observation that the type of models of ownership that one associates in particular with the Anglo-American style of markets of disbursed ownership are not those that prevail in all parts of the world.

To give you one illustration, there are forms of ownership in Europe associated with what are termed industrial foundations, which are companies that are owned by foundations whose predominant purpose is to promote the values and purposes of the businesses that they have dominant shareholdings in. Nova Nordisk actually is a very good illustration. It is a Danish company owned by an industrial foundation that does ensure that there is a consistency of purpose and values in that business.

Corporate governance is predominantly viewed as being about solving what is termed the agency problem of aligning managerial interests with those of their shareholders, again an important function that it has performed in particular since the Cadbury Committee met in 1992.

But in July 2018, the Financial Reporting Council revised the UK corporate governance code away from the notion that corporate governance is about aligning managerial interests with those of their shareholders and the notion that it is about aligning managerial interests with the delivery of the company's purposes. Principle 2 of the Corporate Governance Code says that the board of directors must establish the company's purposes, its values and its strategy and ensure that they and its culture are aligned. The directors should lead by example, act with integrity and promote the desired culture. The next principle goes on and says that the board of directors should ensure that the company has adequate resources to deliver on its objectives and measure its performance by them.

Now, that sums up very well what this is really all about. It is about companies defining their purposes and ensuring that their strategy, their values and their cultures, are aligned with the delivery of those purposes and ensuring that they are investing sufficiently and measuring their performance against the achievement of those purposes.

That comes on to the next two elements which are particularly important in the proposal, and that is in regard to measurement and performance. Currently what we predominantly measure are the physical and financial assets of the firm, and that is basically what accounting statements are about. Increasingly we have come to realise that companies are no longer in many cases predominantly a mixture of financial and physical assets, but they also comprise their workers, their societies and their environment and natural assets, many of which are outside and not within the legal boundaries of the fold. We therefore need to measure those just as we are measuring their physical and financial assets.

Performance at the moment is measured in terms of profits - profits net of the depreciation of the physical assets of the company - but we should be measuring performance also in terms of the extent to which companies deliver on their purposes. To the extent that they fail to do so or fail to maintain their human social and natural assets, then there should be a provision in terms of the cost associated with remedying or rectifying them.

The final set of areas relate to finance and investment. Finance at the moment is very much focused, and a lot of investor protection is predominantly focused, on the rights of investors and the interests of investors, but we are increasingly coming to realise that there is an important role that the financial system performs in terms of promoting the long-term financing of companies with appropriate forms of risk capital. That financing is to invest in not only physical assets within the boundaries of firms to maximise shareholder value, but also to invest throughout the supply chain and in the environment and societies within which companies are operating in light of the importance of those assets for the success of companies.

Think, for example, of Amazon and Uber in regard to human assets, or Google and Facebook in regard to social assets, or airlines and energy companies in relation to environmental assets and natural assets. What this suggests is that if we are to bring about effective reform of business, we have to recognise that what it involves is essentially thinking about the nature of the purposes of a business carefully and what is required to align the achievement of those purposes with the structure of companies and the way in which those companies measure and incentivise people in their organisations.

I want to illustrate this quickly in relation to another example, this time of a company that comes from one of the least well-performing industries over the last decade or so - at least in many countries around the world - and that is the banking sector. I am going to cite an example of what has been one of the most successful banks in the world. It is a bank that earned steadily increasing returns for its shareholders before the financial crisis, during the financial crisis and after the financial crisis; it has one of the best solvency ratios and liquidity ratios of any bank; one of the best credit ratings; it is a bank that has a clearly defined purpose that puts the interests of its customers first; it also seeks to have one of the lowest cost bases of any of its rival banks and it has been very successful over 44 years in achieving both of those things.

It is one of the fastest growing banks in Britain, but it is not a British bank, it is a Swedish bank called Handelsbanken. Indeed, it has had some of the most satisfied customers of any bank and also some of the most loyal customers, which brings out this important notion of reciprocity to which I was just referring - namely, look after your customers and your customers look after you.

What is a key feature of this bank is the way in which it governs its activities. Many of the largest international banks around the world have increasingly centralised control at the top of their organisations, not least spurred on by regulation to do so. This bank does exactly the opposite. It delegates decision-taking down to the level of individual branches to a point that the mantra of the bank is "the branch is the bank". It gives discretion to the branch managers of the bank to determine which customers they are going to deal with, what products they are going to sell them, what price they are going to charge, and whether or not they are going to give them a loan, et cetera.

The importance of that delegation of decision-taking is that it gives discretion to those in the branches to make decisions. They do not have to refer everything up, wait for a decision and then have to tell their customer, "I'm terribly sorry, you can't have your loan". That has been the basis on which it has been able to build up those relationships that have been so important to the success of the bank.

What underpins this is the way in which the bank runs its own activities. It is a humane bank by construction not just in terms of its customers, but also in terms of the people who work in the bank. By that, what it means is that it pays a lot of attention to how it selects people to work and run its branches. It instills the values of the bank firmly into those branch managers and then it says, "Get on and run your branches". It does not incentivise people to do that. It is a bank that pays no bonuses to its employees. Remember how we are continuously told you have to pay bonuses to bank employees if you want to retain and recruit them. Well, it pays none and it is one of the most successful banks in the world. Except for the fact that it pays a bonus when people retire at the age of 60. It is a very long-term incentive scheme.

Now, that brings me on to the final point, because when they retire at the age of 60, people get a share in the profit scheme of the bank called Oktogonen. Oktogonen is one of the main shareholders of Handelsbanken. Handelsbanken is listed on the Swedish stockmarket and it actively trades, but it has two major shareholders, of which Oktogonen and the profit-sharing scheme is one and the other is Industrivärden, a Swedish industrial holding company. If you pose the question who is the main shareholder in Industrivärden, you've guessed it, it is Handelsbanken. It is a cross-shareholding. It is the worst form of corporate ownership and governance you can imagine, only it has been associated with the most successful bank.

That is one of the main points I want to convey, that many of the notions that we have about what's right and wrong in terms of successful business, they are just not borne out by looking around the world at what makes for success.

This brings me on to the final issue that the Chief Justice raised about the impact of this for our capitalist systems. Capitalism, as it is conventionally considered, is an economic system of private ownership of the means of production and their operation for profits. Ownership in this context is a bundle of rights that confers strong forms of authority on their possessors, and firms are nexuses of contracts managed by the boards of directors for the benefit of their owners.

Now, that is a coherent, consistent view of what capitalism is. It is about ownership for profit managed by directors that employ the rest of us through contracts. But I suggest to you that there is an alternative view of what capitalism is about, and that is that capitalism is an economic and social system for producing profitable solutions for the problems of people and the planet, by private and public owners who do not profit from producing problems for people or planet.

In that context, ownership is not just a bundle of rights, but a set of obligations and responsibilities to uphold those purposes. Firms are not just nexuses of contracts, but nexuses of relations of trust based on principles and values enshrined by the boards of directors.

That, too, is a coherent, consistent view of what capitalism is about. It is about solving problems by owners and directors who engage the rest of us through relations of trust as well as contracts. What underpins the conventional view of capitalism is that it is sustained and aligns its interests with our interests through competition - competition in markets for products, for labour, for finance - and where markets fail, we turn to regulation and competition policy.

Now, what this is suggesting is that between market efficiency and regulatory effectiveness, there is a void that is increasingly becoming a chasm as technology accelerates where both markets fail and governance and regulation fail. In that void, we rely on business to transform our individual self-interest into a collective cooperative interest in a common purpose.

Indeed, there is an alternative in which that does not happen, and instead what happens is we experience ever intensifying regulation, and that is indeed what is happening in most countries around the world and, for example, is a likely consequence of the Commission that's just happened in relation to the financial sector here in Australia. But it is not a happy outcome, because it is costly for everybody and at the end of the day, as we have discovered as we go through that process in the UK over the last 10 years, it does not really work, or indeed in the US.

There is an alternative which recognises that what really makes for successful business is the trustworthiness of business and the extent to which it has an element of integrity in terms of being a coherent integral whole that is consistent with what is required, not only to deliver a profit, but also what we as individuals and societies need.

Ultimately, trustworthy businesses are commercially successful businesses and the competitiveness of nations depends on the trustworthiness of its business for the prosperity of the many, not just the few, of the future as well as the present. Thank you.

HER EXCELLENCY: Thank you, Professor Mayer. I think you have already thanked him in the usual way. I think you have set the bar at just the right level. Thank you very much.

DR AUSTIN: Thank you. While the Governor and Professor Mayer are taking their seats, I will introduce and call upon the speakers in the next session. The speaker is Justice James Edelman of the High Court, and the Chair of the session is the President of the Court of Appeal. They should take their places at the bench.

I should say in relation to Professor Mayer's remarkable presentation, not a word of the Chief Justice's challenge was conveyed to him before the event. So we have the Chief Justice setting the scene, laying down the gauntlet, and we have a reply. I am sure you are all considering carefully how to evaluate them. Thank you.