No man is an island in governance

Following Facebook's stock-market plunge, questions should be asked of its governance practices

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On the morning of 26 July, Facebook was valued at $630 billion (£481 billion). By the end of the day, its value had dropped to $510 billion (£389 billion), a 19% drop and one of the biggest one-day losses in US corporate history. It is the largest drop since September 2000, when Intel dropped $91 billion, and at $120 billion is nearly the same as the entire value of McDonald's on the New York Stock Exchange ($122 billion).

Mark Zuckerberg, the company founder saw his personal worth drop by nearly $15 billion and moved him from fourth to sixth on Forbes' list of global billionaires.

The share price plummet came off the back of Facebook's reporting on its second quarter earnings. Although the figures were still positive, they came in below investor expectations and Facebook lowered its outlook on revenue and raised its forecast for expenses.

Tough times

It has undoubtedly been a difficult year for Facebook. The Cambridge Analytica scandal, where the analytics firm gained access to the data of 87 million users, generated numerous negative headlines and a £500,000 fine from the Information Commissioner's Office. Mark Zuckerberg himself appeared in front of the US Senate to address these issues, as well as allegations that Facebook had failed to prevent Russia-linked adverts, designed to influence the 2016 US presidential election, from running.

These scandals may have contributed to the reduction in earnings and the number of European users, which dropped by three million in the first quarter, and a lack of growth in the US market where user numbers have stayed flat. Possibly, the difference in the markets is partially due to the introduction of the EU's General Data Protection Regulation (GDPR) in May, although Facebook's chief operating officer Sheryl Sandberg said on a call with analysts that 'GDPR has not had a significant [advertising] revenue impact, but we also recognize it was not fully rolled out this quarter'.

The role of the board

Any unprecedented loss or failure to hit predicted growth must of course be analysed as a cause for concern, but there are other issues for Facebook, with questions surrounding the makeup of the board and their attitude to corporate governance poentially key to a successful future.

The Cambridge Analytica debacle is also at its core a governance issue. One of the key aspects of Facebook's business model is acting as a data broker, collating personal details in order to more effectively target advertising. If data is the primary asset of the company then it is imperative that governance is robust enough to protect it.

The role of the board in ensuring future growth and protection of data is important. But the Facebook board – comprised of nine individuals, including seven non-executives – has arguably been conspicuous in its absence in the majority of discourse surrounding Facebook's recent issues.

Indeed, Mark Zuckerberg has been central to the company in all respects, but the company needs to expand from its reliance on one man and allow the board a bigger role in order to protect itself.

Benevolent dictator

Zuckerberg's combined role of chairman and chief executive, although not unusual in the US, would likely be strongly opposed on this side of the Atlantic; the Facebook board have faced repeated calls to consider appointing an independent chair, including from major investors. Scott Stringer, the New York City comptroller who oversees a pension fund that has $1 billion invested in Facebook has issued proposals for Facebook to enter a 'reputation-enhancing second chapter', which include appointing an independent chair, recruiting three outside directors who are more experienced than Zuckerberg in the complexities of data and ethics, and creating an independent board committee with oversight of data privacy policies and risks.

Zuckerberg accepted personal blame for the data issues when addressing the Senate, but beyond promises that arguably amount to 'we will do better' there have, so far, been few announcements on improving governance. The board's acceptance of this may seem unusual until we take into account the stronghold that Zuckerberg has over Facebook's voting shares. He has 60% of voting rights, despite only possessing 16% of economic interest. This means that practically speaking, he is near impossible to overrule.

George Dallas, policy director for ICGN, states: 'The governance needs of a company can evolve over its life cycle and this is something that the Facebook board must not forget. Are the skills that helped Zuckerberg to create and build Facebook the same as those the company now requires as it matures?

'Mark Zuckerberg may be regarded by the board now as a worthy leader and benevolent dictator; however benevolence is not necessarily a permanent condition. As the company evolves the board may wish to consider stronger checks and balances on executive power and review the potential for introducing a sunset provision in the existing dual class arrangement. But does the current board have the true independence to consider the challenges to Zuckerberg's power?'

Additionally, this is a 'shareholder-only' company: according to its latest 10-k form, equity consists of almost 90% of the balance sheet. This may not be unusual but does mean that there are few bond holders or bank creditors to exert external influence on the company, increasing the power of the founder.

Peter Swabey, policy and research director at ICSA: The Governance Institute, comments that 'dual-voting rights is an issue that attracts strongly-held views, both for and against. For some, the principle of one-share, one-vote is sacrosanct and any entrenchment of management against the interests of shareholders.

'For others, it creates an investment vehicle where the investment is in the work of the founder who should be untrammelled by the concerns of investors. Dual voting rights entrench the founder, but that can be a good thing, because you are investing in the founder. In a sense, it could be described as a conflict between the view of the shareholder as owner of the company and the shareholder as merely an investor in the company.

'My opinion is that either is fine, provided that the situation is clearly understood by the investor and that restricted voting shares are not included in an investable index so that investors have a meaningful choice as to whether to buy them or not.'

Challenge from shareholders

Facebook's share sistuation may be challenged in the near future, as a Delaware Chancery Court Vice Chancellor J. Travis Laster has called upon Zuckerberg to explain in open court why last year Facebook announced a plan to issue a special class of non-voting stock to accommodate its founder-CEO, retaining voting control of Facebook, long after drawing down his economic interest in the company.

> **Facebook needs to expand from its reliance on one man and allow the board a bigger role**

This reclassification was challenged by a group of institutional shareholders and mere days before Zuckerberg was scheduled to testify in Delaware Chancery Court last September Facebook withdrew the plan. He has now been called upon to appear at an evidentiary hearing, likely to take place in autumn 2018, in connection with ongoing consideration of attorneys' fees in the underlying case.

Ultimately, the drop in share prices is not a disaster of epic proportions. Facebook's growth may be less than predicted, but the associated loss of share value takes them back to the same position that they were in at the beginning of May. If changes are made to how Facebook structures its board and the role that Mark Zuckerberg plays, then the outlook for the robustness of corporate governance is improved as well as potential economic returns. There is a strong case for a revision of the board structure towards a more balanced board with an independent component. n