HELSINKI CAPITAL PARTNERS

FACEBOOK

ESG Analysis

NASDAQ: FB
United States / Media & Entertainment

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General

Facebook is an American company offering online social networking services. Facebook was founded in 2004 by Mark Zuckerberg, Eduardo Saverin, Dustin Moskovitz, and Chris Hughes, all of whom were students at Harvard University. Facebook became the largest social network in the world, with more than one billion users as of 2012, and about half that number were using Facebook every day. The company's headquarters are in Menlo Park, California.

Access to Facebook is free of charge, and the company earns most of its money from advertisements on the Web site. New users can create profiles, upload photos, join a preexisting group, and start new groups. The site has many components, including Timeline, a space on each user's profile page where users can post their content and friends can post messages; Status, which enables users to alert friends to their current location or situation; and News Feed, which informs users of changes to their friends' profiles and status. Users can chat with each other and send each other private messages. Users can signal their approval of content on Facebook with the Like button, a feature that also appears on many other Web sites. (Source: Encyclopedia Britannica, last updated February 7 2019)

The mission of Facebook is to: "Give people the power to build community and bring the world closer together."

Investigation trigger

The HCP Focus fund uses the MSCI ESG - database as a quantitative aid in monitoring the state and trends of ESG issues in portfolio companies.

According to the ESG - policy of the HCP Focus fund, a downgrading of the company ESG - rating constitutes a "red flag" that will trigger an investigation by the fund manager.

In March 2018 the ESG rating of the company was downgraded from BBB to BB by the MSCI ESG - database.

Main current ESG controversies

The MSCI ESG rating report, last updated on 27 March 2018, flagged several ESG controversies related to Facebook, ranging from moderate to severe issues. However, the most severe of the current controversies, and that on which this report will focus, is the so-called "Cambridge Analytica data breach".

In March 2018, a report by The New York Times and The Observer of London revealed that Cambridge Analytica (CA), a data/consulting company, obtained private information from the Facebook profiles of more than 50 million users without their consent. In 2015, a professor associated with CA posted an online personality quiz that attracted 270,000 Facebook users. At that time, while the participants were only 270,000, Facebook's programming interface allowed access to the authorized user's connections. The professor stated that he collected the data for academic uses, however, according to reports, CA used this information for ads-targeting, and eventually political campaign micro-targeting during the 2016 U.S. elections. CA also reportedly committed to deleting the data in 2015, but interviews with employees and review of internal documents revealed that the data was still with the firm. In light of the reports, lawmakers from the United States and the UK demanded an explanation from Facebook. Separately, the Attorney General of Massachusetts launched an investigation against CA and Facebook. (Source: MSCI – ESG controversies report, last updated on 20 December 2018)

HCP Focus ESG and ethical guidelines

According to the ESG and ethical guidelines of the HCP Focus fund, the fund will abstain from investing, divest or introduce in-depth investigation in the following cases:

"Unethical" businesses, i.e. companies with products, services, processes or business-models that are obviously questionable from a moral or ethical point of view. Although such judgement always contains a high dose of subjectivity, my list includes at least products or services that have a clear and substantial addictive and/or destructive potential (e.g. tobacco, hard liquor, gambling, pornography), products the manufacturing of which require vast and unnecessary human or animal suffering (e.g. furs, products made using child-labour) and products with no other discernible purpose but killing human beings (e.g. arms).

Otherwise ethically problematic businesses, i.e. businesses in industries that are: (i) ridden by "grey economy"; (ii) to a substantial part controlled by organized crime, or; (iii) which are widely used for money-laundering. In many developed economies such industries may include construction, restaurants and night-clubs, waste-management etc. In these industries criminal or unethical business practices (corruption, fraud, extortion, tax-evasion) often are the norm, and companies preferring honest means often find it difficult or impossible to compete. (E.g. businesses that are de facto money-laundering operations are usually not managed by and within normal economic constraints (e.g. profitability) and "regular" companies often find them impossible to compete with.)

Portfolio manager analysis

The Cambridge Analytica data breach was without question a significant event. It has been described as a watershed moment in the public understanding of personal data, its uses and misuses particularly on the social media. The scandal was significant for inciting public discussion on ethical standards for social media companies, consultants, and politicians. Consumer advocates called for greater consumer protection in online media and the right to privacy as well as curbs on misinformation and propaganda.

When evaluating the seriousness of the event, at least the following issues should be addressed in light of HCP Focus ESG and ethical guidelines:

(1) Did the company violate its legal obligations towards its customers (i.e. users) or other third parties?

(2) Did the company violate its de facto moral obligations towards its customers or other third parties?

(3) Did the event cause material harm to the company's customers, third parties, or society as a whole?

(4) Does the event constitute material and credible evidence pointing to the conclusion that the business of the company, taken as a whole, has a material negative net impact to the welfare of its customers, third parties, or society as a whole?

Below these issues are addressed.

(1) Legal obligations. The company's terms of service and its data policy gives the company vast ownership of user data. To mitigate the scope of abuse(?), all users have to explicitly agree to accept them when becoming users. Furthermore, users are notified of all updates and amendments. Prospective users that do not accept the terms are free to decline becoming users, and existing users that either change their minds or do not accept amendments to the terms are free to terminate their accounts without notice. It is not clear if the Cambridge Analytica data breach constituted a violation of the company's terms of service and its data policy, and thus it's legal obligations towards its customers.

(2) Moral obligations. The judgment of possible breaches of moral obligations is naturally more subjective and difficult than that of legal ones. Compared to similar cases in more established industries, the difficulty of analyzing the Cambridge Analytica data breach is further increased by the fact that the possible violation took place in a field and industry (social media) that is new, and in which consensus over moral guidelines is still emerging. However, as factual details over the case become widely known, the reactions of the victims of the malpractice - outrage – makes it clear that the consensus seems to be that the company grossly violated its de facto moral obligations towards its customers.

(3) Harm to the company's customers, third parties, and society as a whole. The main harm that the breach seems to have caused is an increase in the general mistrust of the responsible use of used data by big technology companies in general and social media companies in particular. It is also possible that the scandal decreased public trust in the democratic political process itself. However, paradoxically, the case has alerted the public to become more alert to the terms of services and data policy when sharing personal data, and led to call for more vigilance and a stricter code of conduct for those handling data to observe.

(4) The net impact of the business. Social media has become controversial possibly more than ever. Its critics claim that it is addictive, that it fosters tribalism, that it is detrimental to mental/psychological wellbeing (mainly because many users uncritically compare themselves with their more "successful" peers), and that it can be used to spread propaganda, fake news and hate speech by those who are intent on misusing it for their personal, political or other types of gain. On the other hand, according to enthusiasts and defenders, social media is a powerful communication tool that helps people find and keep in touch with friends and family, that fosters co-operation, networking and community building, and that is environmentally less damaging since it enables people to meet virtually instead of physically. The Cambridge Analytica data breach definitely highlighted the problematic aspects of social media. But many existing users are unlikely to give up the social media or Facebook for the event alone or the fear of similar negative incidences occurring in the future. The experience may have led users to become more prudent and alert to some of the risk inherent in social but also traditional media.

Other things to consider:

- Since the eruption of the scandal(s), Facebook has relatively swiftly and decisively addressed many of the systemic weaknesses with respect to election interference, user privacy, transparency and self-regulation. Such concrete measures have included: (a) removing several million fake accounts; (b) suspended more than 400 policy violating apps; (c) increased the head-count of employees specializing in safety and security to over 30,000 persons. It is thus plausible that the probability of similar scandals happening in the future has been significantly reduced. With increased scrutiny and the potential risk to further reputational damage, the company is unlikely to ease its vigilance in the near to mid-term future.

- Without pointing to any alleged conspiracy theory, it is not unthinkable that the ongoing rise of new digital media (e.g. social media), and the corresponding decline of traditional media (e.g. print newspaper and network TV), might color the way the event is presented and discussed in traditional media, with the result of at least some loss of objectivity.

- The rational and objective analysis of the Cambridge Analytica data breach is further complicated by the fact that the events unfolded as part of the highly controversial and polarizing 2016 U.S. presidential elections. This increases the risk that the discussion, analysis and the perceived gravity of the event is influenced by political position of those who steered the subsequent debate and the individuals.

- Social media is a relatively new form of media. Historically, the introduction of new forms of media and entertainment has often triggered suspicion and sometimes outright moral panic, sometimes leading to persecutions and even war. For example, some may see that the Protestant Reformation initiated by Martin Luther was to a certain extent a media revolution; the Gutenberg printed press combined with the translation of the Holy Bible from Latin (which was the exclusive domain of experts, i.e. clergy) into vernacular language led to an involuntary, large-scale transfer of “dangerous” knowledge, previously monopolized by a professional elite, into the hands of “unsophisticated” laymen. Early printed novels were considered a dangerous and addictive form of escapism. More recent examples include the concern surrounding computer and video gaming in light of social exclusion and addiction. It is quite plausible that the current concern about the alleged dangers of social media can in part be explained by this phenomenon over which we can only conclude reasonably in hindsight.

Portfolio manager conclusions and verdict

In the opinion of the portfolio manager, the Cambridge Analytica data breach, although severe, does not, taken as a whole, constitute a breach of fund ESG guidelines serious enough to warrant the divestment of the holding.