

# Client Alert

September 2020

## The New Era of Human Capital Resources Reporting

As we previously [reported](#), in August 2020 the Securities and Exchange Commission (SEC or Commission) adopted a series of amendments to public company disclosure requirements under Regulation S-K. One of these amendments is a new requirement to discuss any human capital measures or objectives that management focuses on in managing the business, to the extent such disclosures would be material to an understanding of the company's business. The new disclosure requirement is effective 30 days after the final rules are published in the Federal Register, and human capital resources disclosure could be an important feature in public companies' next annual reports to investors.

### Background

"Human capital resources" is a flexible concept used broadly to connote a wide range of enterprise-wide employment-related issues, depending on the context, and may include items such as employee demographics, talent development, diversity and inclusion efforts, worker health and safety, compensation design and assessment, employee review and retention, labor-management relations, employment law compliance programs, and overall corporate culture concerning the foregoing matters. Some speakers use the phrase as an umbrella term that includes the full range of these employment issues, and others use it only to encompass a subset of matters. Usage of the "human capital resources" term varies within industries and even at individual companies. As a subset of the larger ESG movement, individual companies' management of human capital has become an increased focus in recent years of not only a growing number of investors, but also a range of other stakeholders including current and prospective employees, customers and consumers, labor unions, NGOs and political activists, to name just a few.

In 2017, the Human Capital Management Coalition (Coalition), a group of institutional investors purporting to manage nearly \$3 trillion in assets, submitted a rulemaking [petition](#) to the SEC urging the agency to adopt rules requiring public companies to disclose information about their human capital management policies, practices and performance. In support of this request, the coalition made the following arguments:

- investors under then-current SEC disclosure requirements could not adequately assess a company's business, risks and prospects without information about how it is managing its human capital;
- greater transparency into human capital matters would allow investors more efficiently to direct capital to higher-value uses, thus lowering the cost of capital for well-managed companies;
- consistent mandatory disclosure standards would obviate the need for companies to respond to a multitude of one-off requests for human capital information from individual investors and level the playing field for smaller investors who do not have the resources or standing to make such requests; and

- human capital management metrics can facilitate long-term investing strategies, which in turn will stabilize our markets and facilitate efficient capital allocation.

In light of the increased investor interest in the topic of human capital resource disclosure and private-sector efforts such as the Coalition's rulemaking petition, the SEC sought public comment on the issue as part of its broader disclosure effectiveness and modernization initiative. Its call for public comment and the Coalition's rulemaking petition elicited a large number of responses on the topic of human capital disclosure, which informed the SEC's final rulemaking efforts.

## The New SEC Rule

The SEC's new human capital disclosure requirements are largely principles-based. Under new Item 101(c)(2)(ii) of Regulation S-K, public companies will be required to provide a description of their human capital resources, including the number of persons employed by the registrant, and any human capital measures or objectives that the registrant focuses on in managing the business (such as, depending on the nature of the registrant's business and workforce, measures or objectives that address the development, attraction and retention of personnel). Disclosure is only required to the extent material to an understanding of the registrant's business taken as a whole, except that, if the information is material to a particular segment, a registrant should additionally identify that segment.

In explaining the standard, the Commission reasoned that human capital is a material resource for many companies and is often a focus of management, in varying ways, as well as an important driver of performance. The SEC specifically declined to adopt a definition of "human capital" as recommended by some commenters because, in the Commission's view, this term may change over time and may be tailored to the circumstances and objectives of individual companies and industries.

According to the SEC's adopting release, the new disclosure should include any human capital measures or objectives that management focuses on in managing the business, to the extent such disclosures would be material to an understanding of the registrant's business. Some examples of relevant human capital measures or objectives the SEC cited include measures or objectives that address the attraction, development, and retention of personnel. The Commission emphasized that these are examples of potentially relevant subjects, and not mandates. The adopting release reminds each public company that disclosure must be tailored to its unique business, workforce, and facts and circumstances.

The SEC chose not to include more prescriptive requirements on the grounds that the exact measures and objectives included in human capital disclosure may be constantly evolving. Moreover, they may depend—and vary significantly—based on factors such as the industry, the various regions or jurisdictions in which a company operates, a company's general strategic posture, including whether and the extent to which it is vertically integrated, as well as economic and other conditions that affect human capital resources, such as national or global health matters.

Additionally, the Commission noted that even though the final amendments do not require registrants to use a disclosure standard or framework to provide human capital disclosure, a principles-based approach affords registrants the flexibility to tailor their disclosures to their unique circumstances, including by providing disclosure in accordance with some or all of the components of any current or future standard or framework that facilitates human capital resource disclosure that is material to an understanding of the registrant's business taken as a whole.

In a change from the proposed version of the rule, public companies will still be required to disclose, to the extent material to an understanding of the company's business, the number of persons it employs. The Commission reasoned that the number of persons employed by a registrant can help investors assess the size and scale of a registrant's operations as well as changes over time. In addition, the Commission believes this disclosure will complement, and could provide essential context to, any discussion of a registrant's human capital management. Although some commenters recommended that the SEC expand this disclosure topic to include additional metrics, such as the number of full-time, part-

time, and contingent workers, and employee turnover, the Commission elected not to adopt such prescriptive elements because doing so would be inconsistent with the objective to make Item 101(c) more principles-based. Nevertheless, the adopting release noted that, under the principles-based approach, to the extent that a measure, for example, of a registrant's part-time employees, full-time employees, independent contractors and contingent workers, and employee turnover, in all or a portion of the registrant's business, is material to an understanding of the registrant's business, the registrant must disclose this information.

## Views of the Commissioners

While the public statements of individual SEC commissioners are not binding on the agency from an administrative law perspective, they can nonetheless be instructive when unpacking a new regulatory requirement.

Commissioner Peirce supported adoption of the various amendments to Regulation S-K, but gave the human capital disclosure requirement lukewarm support, which is consistent with her cautious approach to new ESG disclosure requirements in general. In prepared [remarks](#) she announced that specific human capital disclosures "might be material for some companies under some circumstances, but not for others. Investors are likely to receive more meaningful disclosure about a registrant's workforce from the principles-based requirements adopted today." Commissioner Roisman also supported the amendments to Regulation S-K, but had nothing at all to say about human capital in his official [statement](#).

Commissioners Crenshaw and Lee voted against the new rules, in part because they believed the new human capital disclosure requirement was not broad enough and should have included specific, objective standards.<sup>1</sup>

Only Chairman Clayton, the third (and deciding) vote to approve the new requirement, provided any detailed explanation of human capital in his [public statement](#):

One improvement in today's rules I want to highlight is the topic of human capital. I fully support the requirement in today's rules that companies must describe their human capital resources, including any human capital measures or objectives they focus on in managing the business, to the extent material to an understanding of the company's business as a whole. From a modernization standpoint, today, human capital accounts for and drives long-term business value in many companies much more so than it did 30 years ago. Today's rules reflect that important and multifaceted shift in our domestic and global economy.

Our rules also are designed to elicit disclosure tailored to each company's particular industry and business model, while being flexible enough to continue to allow for fulsome disclosure as businesses evolve in the future. For example, take the final rule's approach to the use of metrics in the area of human capital. As I noted, today's rules require that, in crafting their human capital disclosure, companies must incorporate the key human capital metrics, if any, that they focus on in managing the business, again to the extent material to an understanding of the company's business as a whole. Experience demonstrates that these metrics, including their construction and their use, vary widely from industry to industry and issuer to issuer, depending of a wide array of company-specific factors and strategic judgments. As I have said previously, I would expect that the material human capital information for a manufacturing company will be vastly different from that of a biotech startup, and again vastly different from that of a large healthcare provider. And the human capital considerations for a multi-national car manufacturer will be different from that of a regional home manufacturer. It would run counter to our proven disclosure system, particularly as we first increase regulatory emphasis in an area of such wide variance, for us to attempt to prescribe specific, rigid metrics that would not capture or effectively communicate these substantial differences. That said, under the principles-based approach, I do expect to see

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<sup>1</sup> Commissioner Crenshaw's statement is available [here](#), and Commissioner Lee's statement is [here](#).

meaningful qualitative and quantitative disclosure, including, as appropriate, disclosure of metrics that companies actually use in managing their affairs.

I also want to note that, on a personal level, I continue to believe that many high quality companies tend to invest in and actively manage the development of human capital. I cannot remember engaging with a high quality, lasting company that did not focus on attracting, developing and enhancing its people. To the extent those efforts have a material impact on their performance, I believe investors benefit from understanding the drivers of that performance.

## **Potential Categories of Information for Disclosure**

In the absence of affirmative standards from the SEC, the type of disclosures highlighted in the Coalition's rulemaking petition may be useful starting points for public companies that determine to make human capital disclosures. Specifically, the petition advocated in favor of the following types of baseline disclosures, for which both quantitative or qualitative information could be disclosed, depending on the nature of the information:

- Workforce demographics (e.g., number of full-time and part-time workers, number of contingent workers, policies on and use of subcontracting and outsourcing).
- Workforce stability (e.g., turnover (voluntary and involuntary), internal hire rate).
- Workforce composition (e.g., diversity, pay-equity policies/audits/ratios).
- Workforce skills and capabilities (e.g., training, alignment with business strategy, skills gaps).
- Workforce culture and empowerment (e.g., employee engagement, union representation, work-life initiatives).
- Workforce health and safety (e.g., work-related injuries and fatalities, lost-day rate).
- Workforce productivity (e.g., return on cost of workforce, profit/revenue per full-time employee).
- Human rights commitments and their implementation (e.g., principles used to evaluate risk, constituency consultation processes, supplier due diligence).
- Workforce compensation and incentives (e.g., bonus metrics used for employees below the named executive officer level, measures to counterbalance risks created by incentives).

The petition expressed the view that both specific, rules-based disclosures, such as the amount spent on employee training in the past year, and more open-ended principles-based disclosures like how training expenditures are aligned with a changing business strategy, would provide investors with valuable information about human capital management. We do not necessarily endorse any one particular measure, and of course their materiality will depend on each company's unique facts and circumstances.

## **Additional Considerations in Crafting Human Capital Disclosure**

As companies weigh whether and what to disclose on the topic of human capital resources, we believe a few additional considerations should also be top of mind.

- Because the new standard is principles-based, public companies will have a wide measure of flexibility in crafting appropriate human capital disclosure. Though human capital disclosure is only required in SEC filings to the extent it is material under the federal securities laws, it remains to be seen whether any companies will treat human capital disclosure as positive disclosure

irrespective of whether materiality exists, akin to the way companies have treated risk assessment disclosure as positive disclosure (i.e., voluntarily disclosing that no material risks exist within the company's compensation programs). Companies determining that disclosure is immaterial under the federal securities laws may still elect to provide a human capital narrative in corporate sustainability reports, which are not filed with the SEC, in an effort to address increasing stakeholder demand for such information.

- The new SEC disclosure requirement does not, of course, relieve companies from compliance with federal, state and local labor and employment laws. In crafting human capital policies and disclosures for their SEC reports, companies must continue to take into account employment discrimination laws and other labor regulations. Companies can lawfully take many actions to promote the laudable goal of advancing diversity in their workforce, for example, but they must continue to be mindful of potential claims that could seek to challenge these efforts as discriminatory in one way or another. The new disclosure rule may spur future innovations in compensation design to better give effect to diversity and inclusion efforts.
- In addition to the human capital metrics cited in the Coalition petition above, a host of other private-sector standard-setters have also developed a wide range of their own suggested human capital disclosures, which vary based on country, industry and numerous other subjective factors. An entire cottage industry has evolved to provide human capital and other ESG metrics, rankings and consulting services for both investors and public companies. Registrants that determine to make human capital disclosures in SEC filings should carefully consider which of these metrics are most appropriate for their businesses, giving attention to preferences of their own investors, who may favor some sets of metrics over others based on various idiosyncratic factors.
- Human resources executives and counsel can play a key role in implementing effective human capital programs and reviewing public disclosures, especially diversity, equity and other social disclosures in the proxy statement, annual report and other SEC filings. Indeed, human resources counsel and executives who have historically had a nominal role in the SEC disclosure review process and often have not been part of the disclosure review committee may now need to feature more prominently in these procedures.
- Recently, a number of prominent public companies have been the subject of shareholder litigation regarding human capital issues. These suits typically allege violations of board fiduciary duties for not maintaining a sufficiently diverse workforce in one way or another. They also claim that the companies violated the antifraud provisions of the federal securities laws by touting diversity efforts and achievements in proxy statements and other SEC filings even though such statements were allegedly untrue. The litigation is at too early a stage to draw any affirmative conclusions, but it is clear that some shareholders (and plaintiffs' counsel) are now focused on these issues and have begun to look for potential misstatements and omissions on such matters in companies' public statements.
- In light of the foregoing, boards and compensation committees may need to expand their oversight of human capital matters, particular those affecting rank-and-file employees. These efforts will vary by company, but may include enhanced discussion and review of compensation design, material employment litigation, internal investigations and shareholder communications regarding employee welfare and diversity. Board and committee governance principles and charters, as well as annual self-evaluations, may need to expand as appropriate to cover diversity, inclusion and other human capital issues. Meeting agendas may need to expand to give due attention to these issues, which in turn could affect the frequency and duration of board and committee meetings. Board recruitment efforts may need to expand to ensure that sufficient expertise in these topics resides on the full board and the compensation committee. Of course, any expansion of the board's oversight must be balanced against heightened litigation risks associated with involving the board in enterprise-wide employment decisions.

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