ALERT

October 5, 2023

SEC INVESTOR ADVISORY COMMITTEE RECOMMENDATIONS WOULD SUBSTANTIALLY INCREASE HUMAN CAPITAL MANAGEMENT DISCLOSURES

At its September 21, 2023 meeting, the SEC Investor Advisory Committee (IAC) approved a report to the SEC containing recommendations that, if agreed to by the SEC, will dramatically expand the 2020 rules requiring human capital management (HCM) disclosures in 10-K filings. Specifically, the IAC recommends the expansion of required disclosures to include:

1. The number of people employed by the issuer, broken down by whether those people are full-time, part-time, or contingent workers;
2. Turnover or comparable workforce stability metrics;
3. The total cost of the issuer's workforce, broken down into major components of compensation;
4. Workforce demographic data sufficient to allow investors to understand the issuer's efforts to access and develop new sources of talent, and to evaluate the effectiveness of these efforts; and
5. Narrative disclosure of how the issuer's labor practices, compensation incentives, and staffing fit within the broader firm strategy.

The IAC is appointed by the SEC and makes recommendations to the SEC regarding the SEC's rules and regulations. At its September 21, 2023 meeting, the IAC approved a report by one of its subcommittees containing recommendations (link) that would dramatically expand the 2020 rules requiring HCM disclosures in 10-K filings after November 8, 2020 if they are approved by the SEC. The 2020 HCM rules were discussed in our Alerts dated November 27, 2020 (link) and April 8, 2021 (link).

An IAC recommendation is an early stage in the process of changing the HCM disclosure rules. The SEC has to decide whether to change the rules and then publish proposed changes. After a comment period, the new changes would be finalized. The SEC has indicated that October 2023 is the timeframe targeted for proposing enhanced HCM disclosures.

It is tempting to wait and see what the SEC recommends and then to comment, if warranted. On the other hand, once proposed rules are published, it is harder to change the SEC's direction. We think companies should thus study the IAC recommendations and, depending on their reaction, consider registering their thoughts now, either directly or with their applicable trade and/or practice group(s).

Background

The SEC significantly revised the contents of Form 10-K, effective November 9, 2020. Prior to the 2020 rules, in the description of a Company's business, the only required HCM disclosure was the total number of employees (and, in some cases, by segment). The 2020 rules, under Item 101(c)(2) of Regulation S-K, require a registrant to discuss "to the extent material to an understanding of the registrant's business taken as a whole" the following:

> "A description of the registrant's 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)."

The new principles-based requirement left registrants with significant leeway in determining what to discuss with respect to HCM and some in the investor and academic communities felt the new rules did not go far enough. As noted above, the SEC is currently working on a proposal to mandate enhanced HCM disclosures and the IAC draft recommendations are an effort to shape such proposal. The IAC believes that the enhanced disclosures "would allow investors to more efficiently direct capital" by having access to more robust, consistent and comparable information. Specifically, the IAC recommends expanding Item 101(c) disclosure to include:

1. The number of people employed by the issuer, broken down by whether those people are full-time, part-time, or contingent workers;
2. Turnover or comparable workforce stability metrics;
3. The total cost of the issuer's workforce, broken down into major components of compensation; and
4. Workforce demographic data sufficient to allow investors to understand the issuer's efforts to access and develop new sources of talent, and to evaluate the effectiveness of these efforts.

Further, the IAC recommendations include narrative disclosure, in the Management Discussion & Analysis, of how the issuer's labor practices, compensation incentives, and staffing fit within the broader firm strategy. According to the draft recommendation, "[s]uch a discussion would address what portion of labor costs management views as an investment and why, including how labor is allocated across areas designed to promote firm growth (e.g., R&D) and those necessary to maintain current operations rather than increase sales revenue (e.g., compliance)."

As described in this Alert, while there may be some rationale for each of the proposed requirements, there could be significant costs and complexities associated with compliance.

Proposed, Expanded HCM Disclosures

1. The number of people employed by the issuer, broken down by whether those people are full-time, part-time, or contingent workers

Rationale. Investors would benefit from consistent headcount disclosures that break down full-time, part-time, and contingent workers. This would allow them to "contextualize information about workforce changes."

Disclosure Concerns. The IAC uses the term "contingent workers" to refer to both independent contractors and leased employees. Accumulating these data could impose significant new burdens on an issuer. For example, if the headcount is to be determined as of a given day, how do you determine if an independent contractor is performing work on that day? In addition, at times the issuer may not have access to the relevant headcount information. If an issuer contracts for nightly security services, for example, it does not necessarily know if a particular eight-hour shift is fulfilled by one employee or two employees working four-hour shifts. These difficulties will be compounded if the headcount must be reported by business unit or division, a possibility that is left open by the recommendation. If the SEC adopts this recommendation, guidance would be required as to how issuers are to estimate headcount with respect to contingent workers.

The recommendation that headcount data include independent contractors and leased employees does not acknowledge that the SEC previously encountered this issue in the context of the CEO pay ratio rules enacted by the Dodd-Frank Wall Street Reform and Consumer Protection Act. The pay ratio rules require disclosure of the ratio of CEO pay to that of the median paid employee. The SEC originally proposed a definition of employee that would have included some independent contractors and leased employees, but, in the face of widespread criticism with regard to the unworkability of such a standard, retracted its initial position in 2017 and allowed the test to be conducted using only common-law employees. This issue is covered in our Alert of October 4, 2017 (link).

2. Turnover or comparable workforce stability metrics

Rationale. Turnover is a financially meaningful metric that can be compared across companies.

Disclosure Concerns. How complex it will be to comply with this requirement depends on how it is defined. If the rules simply require counting all persons shown as employees at the start of the year and then determining how many are still employees at the end of the year, the computation may not be overly difficult. On the other hand, if contingent workers are to be taken into account, the turnover computation could be very complex. Suppose an employee becomes an independent contractor or a leased employee stops working for the issuer because she is reassigned. It is not clear how these situations would be handled. Further, while the IAC recommendation does not discuss whether turnover data will need to be broken out by job category (executives, managers, etc.), a logical concern is that a requirement to list turnover data will eventually expand to a listing by job category.

Beyond compliance issues, we also have some questions about the rationale, or at least the evidence provided in the report. Since the IAC report laments the lack of reliable turnover data, we were somewhat surprised to see references to studies showing a negative correlation between turnover and various measures of economic success, i.e., higher turnover is associated with worse results in relation to various measures of profitability. If there are no reliable data, how can there be such studies? At least two of the studies appeared to base their conclusions on data from the same labor analytics firm, which firm “continuously gathers unstructured data containing employees’ online profiles and resumes from various websites and social media platforms . . . and uses proprietary algorithms to extract employment data.” This suggests that the turnover data are based on employees’ self-reporting and using formulas that are not publicly disclosed. It seems unfortunate that a major policy decision should be based on these kinds of data.

Correlation is not causation: If an issuer is profitable with growing sales and a growing workforce, one would expect there to be lower turnover than is the case of a company that is unprofitable with declining sales and a flat/declining workforce. In the first case, the growing company offers more opportunity for promotions, a rising stock price that increases the value of equity grants, and the potential need and ability to pay higher wages to keep adding employees. All the opposite factors are at work in the second case. It is unsurprising that higher profitability and employee retention are correlated, but that is not the question—the question is whether better retention is the cause or the effect of the higher profitability. In fact, one of the papers favorably cited by the IAC explicitly noted that the paper did “not examine whether employee turnover causes lower performance.”

3. The total cost of the issuer’s workforce, broken down into major components of compensation

Rationale. Labor costs are a significant operating cost and investors would benefit from such costs being broken out from other line-item expenses, by major component, to allow investors to evaluate the dollars invested in human capital.

Disclosure Concerns. It appears the recommendation would include total amounts paid for contingent workers. This will lead to an apples-to-oranges comparison, since the compensation costs for contingent workers will include the amounts paid to their employer for the costs of running the business, i.e., the costs of the leasing company.

In addition, the recommendation is for costs to be broken down into categories, referring approvingly to the way executive compensation is reported in the Summary Compensation Table mandated by Item 402(c) of Regulation S-K. Gathering these data may prove quite cumbersome considering the many complexities involved in computing the compensation data for the Summary Compensation Table (and that the Summary Compensation Table covers only a handful of people).

We were again struck by how the IAC’s recommendation makes no reference to the fact that the SEC wrestled with the complexities of determining total compensation in deciding how an issuer could determine its median employee for the purpose of the pay ratio rule. As described in our October 4, 2017 Alert (link), the SEC allows the median employee to be determined by using a “consistently applied compensation measure” (such as W-2 pay), even if this does not include all elements of compensation.

4. Workforce demographic data sufficient to allow investors to understand the company's efforts to access and develop new sources of talent, and to evaluate the effectiveness of these efforts

Rationale. Given the importance of human capital and the importance of diversity in decision making, investors need to understand how a company is sourcing and developing diverse talent.

Disclosure Concerns. The text accompanying this recommendation indicates that the IAC wants the issuer to publish the demographic data contained in the EEOC's Form EEO-1, which is annually filled out by all large employers. The firm reports on the racial/ethnic/sexual composition of the workforce across a variety of different job categories, such as executives, mid-level managers, sales workers, etc. The data are currently not required to be publicly available although some companies have begun to publish at least some of the information contained in the form.

To use the language of the recommendation, will the raw data in the EEO-1 by itself allow an investor to understand "the company's efforts to access and develop new sources of talent, and to evaluate the effectiveness of these efforts"? Since the data only shows outcomes, it has little to say about efforts. It is not unreasonable to think that this recommendation might eventually expand into a requirement of a description of the actual efforts being undertaken by the issuer to achieve diversity goals.

Without questioning the value of diversity, one can also observe that the causation/correlation problem may exist also with this metric. Suppose, for example, two companies, A and B, that start out with the same size workforce and each workforce is 10% diverse. Through successful recruiting efforts, the employee population added by both companies is 20% diverse. If one company adds employees more quickly, it can be shown that the company that is growing faster will end up with a higher diversity percentage. Some part of the disparity may simply reflect higher profitability driving higher employee growth, rather than the other way around. An issuer concerned about the impact of the IAC proposals may want to explore the methodology used in the diversity studies cited by the IAC to understand how the correlation/causation issue was addressed.

5. MD&A discussion of how the firm's labor practices, compensation incentives, and staffing fit within the broader firm strategy

Rationale. The IAC draft does not include specific rationale for this recommendation; however, the drive appears to be to provide narrative to complement the requested, additional metrics to provide investors with a fuller picture of how an issuer's HCM strategy fits within the overall company strategy.

Disclosure Concerns. The recommendation about discussing the relationship between a firm's overall strategy and its labor practices, compensation incentives, and staffing is similar to the requirement that the Compensation Discussion & Analysis (CD&A) required by Item 402(b) of Regulation S-K discuss the objectives of its compensation program for its "named executive officers" except that the disclosure would relate to the entire employee population. We would not be surprised if this language results in something generic like the common CD&A statement that the firm's compensation programs are designed to attract, retain, and incentive the best talent.

Unlike the CD&A, however, there are two novel requirements in this recommendation. First, management needs to explain what portion of labor costs are viewed as an “investment.” If taken at face value, this will require setting up new recordkeeping systems. For example, when an exempt salaried employee spends time training junior personnel, that seems like an investment. So, the salaried employee will need to fill out a form detailing hours spent preparing for and engaging in this activity, which will then need to be prorated against total hours spent by that employee for the year, which will now need to be tracked.

There is also a new requirement to divide labor costs into those that promote firm growth and those necessary to maintain current operations. We find this requirement difficult to understand, let alone implement, and expect that issuers would approach it in many different ways. What about the administrative assistant? Do we have to find out what portion of the administrative assistant’s time is spent on compliance-type activities, like expense reports vs. assisting with new business proposals to “promote growth.” Must every meeting be labeled as “promoting firm growth” vs. “maintaining current operations.” Our first reaction is that companies will spend a startling amount of time trying to figure out how to comply with these new requirements and there is no chance companies will come up with identical approaches.

In addition, depending on how the information is presented, companies may be concerned that the disclosure has the potential to result in competitive harm.

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