Securities Regulation Daily Wrap Up, TOP STORY—SEC advisory committee approves human capital disclosure recommendation despite member concerns, (Mar. 28, 2019)

Securities Regulation Daily Wrap Up

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While several committee members expressed doubt about the document's specific examples on human capital disclosure, the recommendation was approved by a vote of 14 to 6.

In an unusually contentious panel discussion at the SEC's Investor Advisory Committee (IAC), the Investor-as-Owner Subcommittee's recommendation on human capital management disclosure was approved by the IAC, with several members dissenting. While all committee members praised the work of the subcommittee on developing the recommendation, several members expressed concerns that a list of examples contained in the recommendation could be perceived as going beyond suggestions for disclosure to the point where they would be expected or even required.

Remarks of Clayton and Roisman. In his opening remarks greeting IAC members, SEC Chairman Jay Clayton recalled his February 6 call with Commissioner Elad Roisman and members of the IAC, in which he elucidated his views on how the Commission should approach the regulation of disclosures by public companies. Clayton reiterated his belief that SEC regulation and guidance regarding disclosure must be rooted in the principles of: (1) materiality; (2) comparability; (3) flexibility; (4) efficiency; and (5) responsibility. In addressing possible regulations relating to human capital disclosures, Clayton warned against imposing rigid standards or metrics for all public companies.

Roisman echoed the chairman's remarks warning against establishing a rigid regime for the disclosure of human capital issues. In particular, Roisman explained that every industry, and indeed every company, has its own human capital requirements. He added that the current principles-based disclosure regime provides companies flexibility to provide material human capital disclosures that reflect the company's particular circumstances. However, he assured that he is open to hearing all views on the subject.

Recommendation. Harvard Law School Professor John Coates presented the subcommittee's recommendation to the full committee. The five-page recommendation advises that for the most dynamic of public companies in the current economy, human capital is the primary source of value. The SEC's disclosure regime should recognize that the U.S. economy has transitioned from being almost entirely based on industrial production to technology and services, which stresses the importance of intangible assets such as human capital, according to the recommendation.

The recommendation also emphasized that while the SEC's historical view is that human capital is a cost, the financial markets have shifted to view it as a source of value. The SEC's disclosure frameworks have not kept pace with this shift towards the view that human capital management (HCM) is a source of value, according to the recommendation.

The recommendation advises that the Commission recognize the significance of HCM and incorporate it as a part of the SEC's disclosure effectiveness review, including augmenting existing principles-based disclosure requirements with explicit discussions of human capital. The recommendation includes a number of examples that the Commission could consider as possible human capital disclosures. These include:

- breaking down the current Regulation S-K requirement of the disclosure on number of people employed at a company to include full-time, part-time, and contingent workers;

- summarizing data on the education, experience, and training of its workforce;
- including measures of worker productivity; and
- including how current disclosures of executive compensation can be augmented to include summaries of broader workforce compensation and incentive structures.

Coates explained that the subcommittee's recommendation meets the approach favored by Chairman Clayton. Any new disclosure will be subject to a materiality standard, he said. Regarding flexibility, Coates said that the subcommittee specifically endorsed a principles-based disclosure regime, so concerns about rigidity should hopefully be allayed. On the issue of comparability, Coates noted that the subcommittee wants the Commission to ensure that companies are not changing the way they make human capital disclosures from quarter-to-quarter just to make themselves look good.

Addressing the chairman's concern about efficiency, Coates suggested that the SEC canvas companies about the information they are already collecting and tracking, which could help reduce costs in the event of any new regulations. Finally, regarding responsibility, Coates noted that overall recommendation is designed to take account that the market pricing of public companies has moved away from traditional financial accounting.

Naysayers speak up. A number of IAC members, while being generally supportive of the idea of disclosure of human capital issues by public companies, were reluctant to support the subcommittee's recommendation. Some members in particular citied the list of examples in the recommendation that they fear might be part of any new human capital disclosure regulation. Stephen Holmes, General Partner Emeritus at InterWest Partners, stated that he liked the first three pages of the five-page document, but had concerns about the last two pages, which listed potential HCM disclosure areas. He said that in his experience, even when a list is written as simple examples, it can quickly become the de facto expectation, even though it is not appropriate for all issuers. Professor Paul Mahoney of the University of Virginia School of Law concurred stating that he was worried that the specific examples enumerated in the recommendation might look like instructions to management on how to operate their business.

J.W. Verret, Associate Professor of Law at George Mason University Antonin Scalia Law School, said that he doesn't disagree that human capital disclosures are important to many investors, but that does not mean they should be mandated. Under pressure from investors, companies have an incentive to voluntarily make human capital disclosures, including in their use of non-GAAP measures. He also voiced his concern that requiring certain human capital disclosures might force firms to reveal proprietary information on their human capital strategies. In addition, he said that some human capital factors such as pensions, while regularly viewed as a net asset, are actually a net liability.

Lydia Mashburn of the Cato Institute echoed her fellow committee members' concerns about the recommendation's list of examples. She said that when specific examples are listed, even when they are just examples, there is a tendency to "play to the metric." For instance, she said that some companies may engage in training programs because it looks good when they disclose these training programs, even if no employees attended the training or if it was not relevant to their employment.

Cheerleaders respond. Several committee members responded to the dissenters by emphasizing that the recommendation is simply that, a recommendation to the Commission, not a final rule, a proposal, or a concept release. Regarding the specific examples that some members took issue with, Coates said that the subcommittee did not invent them and that they will be part of the discussion whether they had been included in the recommendation or not.

AFL-CIO Director of Policy and Special Counsel Damon Silvers was surprised at the opposition of some of his fellow committee members, stating that he thought the recommendation was a "rather modest document" that seeks to apply existing management disclosure regulations to human capital management disclosures. Some of the dissenting opinions, Silvers opined, seemed to be based not on the recommendation itself, but by arguments about securities regulation in general.

Barb Roper, director of investor protection at the Consumer Federation of America, emphasized that the recommendation was meant to start a conversation at the Commission on human capital disclosures. The recommendation document is part of a two-phase process: the first phase asks that Commission staff develop a possible narrative for the disclosure of human capital issues; and the second phase is whether the Commission will go forward with the issue, or not, Roper explained.

Heidi Stam, former managing director and general counsel at Vanguard, a member of the subcommittee that submitted the recommendation, said that she would be personally opposed to some of the specific metrics outlined in the recommendation that had caused other members consternation. However, it is still a valuable conversation to have, she said.

The IAC voted to approve the recommendation by a vote of 14 to 6.

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