Human Capital Management Disclosure: A Reminder

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Item 101(c)(2)(ii) of Regulation S-K requires public companies to describe, to the extent material to an understanding of the issuer's business taken as a whole, any human capital measures or objectives that the issuer focuses on in managing the business, such as measures or objectives that address the development, attraction and retention of personnel. If any of this information is material to a particular segment of the issuer's business, the issuer must identify the segment in the disclosure. Like other parts of Regulation S-K, most notably the Compensation Discussion & Analysis ("CD&A") section of an annual proxy and the requirement of Item 402(s) to consider compensation risk, the rule is open ended in its scope—for example, it does not prescribe a specific definition of "human capital" or require the disclosure of any specific measures or objectives—and thus invites issuers to frame their responses by reference to their own specific businesses, peer groups and industries.

Item 101(c)(2)(ii) became effective in November 2020. In the rule's first year on the books, issuers have taken a variety of different disclosure approaches, including with respect to the types of topics covered, the length and depth of the disclosure and whether specific metrics are disclosed. The topics covered have included workforce talent development, diversity and inclusion, employee relations, employee turnover, workforce culture topics, retention initiatives, employee health and safety (including COVID-19), compensation and benefits matters and succession planning. Some issuers have used their human capital disclosure to discuss at length initiatives that they have proudly undertaken, while others have opted for a more minimalist approach to satisfying the applicable disclosure requirements.

In this Debevoise In Depth, we focus on what the rule *requires* to be disclosed. We also offer guidance that this area of disclosure is particularly fluid. Disclosure decisions made now will likely form a baseline that affects future human capital disclosures. Because human capital management is a recurring portion of the annual reporting, how an issuer addresses these requirements may set market and Securities Exchange Commission ("SEC") expectations as to what the issuer discloses annually on a going-forward basis. Additionally, we preview new, more prescriptive requirements that may be right around the corner, of which issuers should be cognizant as they refine their disclosures for the current 10-K and proxy season.

What Measures and Objectives Should Be Disclosed under Item 101(c)(2)(ii) of Regulation S-K?

There is no one-size-fits-all approach to the disclosure requirements. As noted by the SEC in the final adopting release, the disclosure "must be tailored to [an issuer's] unique business, workforce, and facts and circumstances." The SEC did not include more prescriptive requirements in recognition of the fact that, as described in the final adopting release, "the exact measures and objectives included in human capital management disclosure may evolve over time and may depend, and vary significantly, based on factors such as the industry, the various regions or jurisdictions in which the registrant operates, the general strategic posture of the registrant, including whether and the extent to which the registrant is vertically integrated, as well as the then-current macroeconomic and other conditions that affect human capital resources, such as national or global health matters."

The wide variance to date in the disclosures on human capital management is to be expected as the impact and importance of human capital varies significantly among industries and businesses, and in evolving market conditions. The SEC's principles-based approach to the rule invites variations to accommodate these differences, as well as variations arising from different approaches toward satisfying the open-ended direction to assess an issuer's measures of human capital and to then craft the issuer's story. Because human capital assets walk, talk and "leave the building at night," the factors pertinent to human capital are likely to evolve quickly, change in emphasis annually and shift with changes in personnel, perceptions in the marketplace and the expectations of employees. We expect that general economic conditions, including the variations in the labor market, may also affect an issuer's focus, and (by way of example) the factors applicable to the C-Suite may differ from the factors applicable among the more rank-and-file employees. As such disclosure becomes a recurring component of an issuer's annual reporting, both the SEC and investors may reasonably come to expect issuers to address both the factors they have focused on in the most recent reporting period and how and why these factors have changed from prior reporting periods.

In determining what human capital measures or objectives *must be* disclosed under Item 101(c)(2)(ii), there are two key questions: (1) is this measure or objective a focus of the issuer in managing the business, *and* (2) is it material to an understanding of the issuer's business taken as a whole? If the answer to both of the above questions is *yes*, the measure or objective is required to be disclosed in response to Item 101(c)(2)(ii).

Is this human capital measure or objective a focus of the issuer in managing the business?

The SEC noted in its proposing release for the proposed rule that "investors would be better served by understanding how each issuer looks at its human capital and, in particular, where management focuses its attention in this space." The intent of the rule, according to the SEC's proposing release, is "to elicit, to the extent material to an understanding of the registrant's business, disclosures regarding human capital that allow investors to better understand and evaluate this company resource and to see through the eyes of management how this resource is managed."

Is this human capital measure or objective material to an understanding of the issuer's business taken as a whole?

As described above, this inquiry is fact-specific to each issuer. How dependent an issuer's performance is on the success of its workforce, and which components of its workforce, will vary widely across industries and businesses within industries. For example, a small biotech company may be heavily dependent on the research and development abilities of those developing new products, while the success of a more established pharmaceutical company may depend heavily on the success of its salesforce in producing demand for its established products. Some businesses will rely more heavily on interpersonal relationships with customers, while others will succeed or not based on the ability to produce and ship reliable products. Training initiatives will also vary radically depending on the complexity of the tasks performed, the extent to which a business is customer facing and the extent to which turnover is common in an industry or locale.

In determining whether a measure or objective is material, a well-run company's own practices and policies should provide clear insights and guidance. Its compensation policies and practices should inform which elements of human capital are critical to its success, as its practices should be designed to reward developing its human capital in ways that meet its needs. Other factors that may inform the determination of materiality are whether this measure (or particular aspects thereof) are reported to the board of directors, the extent to which expenditures for training and advancement are important components of the budget and whether and to what extent developing human capital is a factor in measuring the incentive arrangements for all executives (and not just those human resource professionals who have direct responsibility for such matters).

As described above, the answers to the two questions posited by Item 101(c)(2)(ii)—and thus what is required to be disclosed—may and most likely will evolve over time. For example, during the "Great Resignation," efforts to reduce turnover and bolster retention may be a critical factor in managing the business in 2022 and material to an understanding of the business taken as a whole. However, in a future year, where turnover stabilizes, the issuer's ordinary course retention efforts may not be required to be disclosed.

Should Issuers Disclose More Than Is Required by the Rule?

The scope of the rule can be fairly interpreted as an invitation for issuers to discuss human capital factors broadly and at length, and all issuers should be thoughtful on the question of scope before putting pen to paper. With increased interest from some shareholder groups on environmental, social and governance ("ESG") matters and diversity, equity and inclusion factors, some issuers may consider discussing, or feel compelled to discuss, human capital measures or objectives that are not otherwise required to be disclosed by the rule—*e.g.*, because they are not material to the issuer's business taken as a whole. An issuer that concludes that a narrow (or no) disclosure is appropriate is not without any outlet: for example, information not required to be disclosed by Item 101(c)(2)(ii) may be shared with investors in other forums, such as sustainability or ESG reports or in diversity and inclusion reports or investor or industry presentations posted to issuer websites that provide information and disclosures beyond what would be required by Item 101(c)(2)(ii). Care should be taken when considering whether to disclose information that is not required to be disclosed even when there is reason to be especially proud of the efforts related to human capital development, as this may create an expectation of a similar level of continuing disclosure, including in periods where other business priorities may make the efforts in regard to human capital initiatives less compelling. As we have seen with compensation risk disclosures under Item 402(s), an issuer that decides to make fulsome human capital management disclosures should not view this as a one-time decision but instead as a commitment to an ongoing stream of disclosures.

In addition, voluntary disclosure of human capital metrics that are relatively new for the issuer and that change in subsequent years may then necessitate additional disclosure regarding those changes to the metrics or the underlying definitions. This point was emphasized in an August 2020 statement by former SEC Chair Jay Clayton when the human capital management rule was under consideration. Regarding the quantitative disclosure of human capital metrics, former Chair Clayton noted, "[a]s is the case with non-GAAP financial measures, I would also expect companies to maintain metric definitions constant from period to period or to disclose prominently any changes to the metrics used or the definitions of those metrics." In this situation (again, comparable to SEC guidance on the CD&A), the issuer would, in future disclosures, likely feel both SEC and market pressure to explain how and why its focus has changed.

What May Be Coming?

Another consideration for issuers deciding on the scope of their human capital disclosures is that some of the considerations above may be preempted by more prescriptive, quantitative requirements on human capital management disclosure that are likely around the corner. The SEC's Fall 2021 rulemaking agenda noted that the SEC is considering recommending that the SEC propose rule amendments to enhance registrant disclosures regarding human capital management. SEC Chair Gary Gensler previewed earlier in 2021 that he had asked the SEC Staff to propose recommendations on mandatory disclosures on human capital. In remarks delivered on June 23, 2021 at London City Week, echoed in a subsequent tweet in August 2021, Chair Gensler noted that this required disclosure "could include a number of metrics, such as workforce turnover, skills and development training, compensation, benefits, workforce demographics including diversity, and health and safety." In support of more prescriptive human capital disclosures, SEC Commissioner Allison Herren Lee dissented from the adoption of the final human capital rule, stating in August 2020, "I would have supported [the] final rule if it had included even minimal expansion on the topic of human capital to include simple, commonly kept metrics such as part time vs. full time workers, workforce expenses, turnover, and diversity."

Public companies may want to consider these potential changes in addressing their responses to the current principles-based rule, in terms of both recognizing what the current leadership at the SEC considers to be of importance to investors and being cognizant of these additional topics that may have to be addressed in the future when considering emphasizing current or recent human capital initiatives.

We will continue to monitor and update our clients on any developments in this area.

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