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COMMITTEES:
FINANCE
BANKING, HOUSING, AND URBAN AFFAIRS
BUDGET
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RULES AND ADMINISTRATION

United States Senate
WASHINGTON, DC 20510-4606

July 19, 2018

The Honorable Jay Clayton
Chairman
Securities and Exchange Commission
100 F Street, N.E.
Washington, DC 20549

Dear Chairman Clayton:

Human capital is among a company's most valuable assets. The United States has led the world economy from the production of manufactured goods to the production of services and intellectual capital-intensive goods. As the global economy continues to transition to a 21st-century knowledge-based economy, effective human capital management will be critical to a firm's ability to innovate, adapt, and compete.

Yet the Securities and Exchange Commission's (SEC) Regulation S-K requires few human capital management disclosures from public companies. Regulation S-K's only disclosure requirements on human capital are Item 101(c)(1)(xiii), in the "Narrative Description of Business" section, regarding a registrant's number of employees, and Item 402, requiring a registrant to disclose the median pay of all employees and the compensation of its CEO.[1] Although knowing the number of employees at a company and their median compensation is useful to investors, it is hard to see why a company's management, assessment, and training of that human capital should not be considered material. Without that information, investors do not have the ability to adequately assess the current performance and future prospects of a company. You have also raised the issue of the importance of adequate human capital disclosures, most recently in April 2018 at a House Appropriations Subcommittee on Financial Services and General Government hearing, where you stated that you "would like to see more disclosure from public companies on how they think about human capital."

In light of increasing investor interest, I believe the time is right for the SEC to revise Regulation S-K to require public reporting companies to disclose more qualitative and

[1] The lack of attention to human capital management in current Regulation S-K contrasts sharply with Item 102 of Regulation S-K, which requires disclosure of "the location and general character of the principal plants, mines and other materially important physical properties of the registrant and its subsidiaries," including the identification of "the segment(s), as reported in the financial statements, that use the properties described," and any encumbrances on those properties. Given business and economic trends that make physical properties less important today for many companies—and human capital requirements more important—the disparity in requirements for these categories is striking.

quantitative information regarding their human capital management policies and practices.

There is evidence that strong human capital management policies correlate with corporate performance.[2] For example, using a survey dataset of 2,000 large firms, researchers at Harvard Law School's Labor and Worklife Program found in 2015 that human capital policies are material to long-term financial performance and success.[3] By evaluating over 92 empirical studies that examined the relationship between human resource policies and financial outcomes, such as return on equity, return on investment, and profit margins, the research finds sufficient evidence of the materiality of human capital management to financial performance to prompt inclusion in disclosures.

Given the effect of human capital policies on a company's financial performance, it is sensible that institutional investors are increasingly interested in the disclosure of human capital metrics. As the Human Capital Management Coalition has noted, 1,500 investors representing $62 trillion in assets under management have signed the UN-backed Principles for Responsible Investment, agreeing to incorporate broad environmental, social, and governance (ESG) issues into investment decisions and request ESG disclosures from companies.[4] Many commenters highlighted their interest in greater disclosure of ESG matters in response to the Commission's 2016 "Concept Release" requesting public input on modernizing the disclosure requirements in Regulation S-K. On human capital, specifically, the Council of Institutional Investors (CII) noted that "executives surveyed in 2011 by The Conference Board ranked risks related to human capital fourth out of 11 categories of risk, above supply chain, IT, and reputational risks."[5]

Companies are increasingly responding to growing interest in ESG issues by reporting more broadly on it, though not uniformly. The United States trails many foreign countries in addressing the public demand.[6] According to the Sustainability Accounting Standards Board, company disclosure on ESG issues within industries in the United States varies

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[2] Kenneth A. Bertsch, Executive Director, Council of Institutional Investors. Letter on "Concept Release: Business and Financial Disclosure Required by Regulation S-K." (July 8, 2016)

[3] Aaron Bernstein and Larry Beeferman. "The Materiality of Human Capital to Corporate Financial Performance." Report by the Harvard Law School Labor and Worklife Program, funded by the Investor Responsibility Research Career Institute. (2015)

[4] Principles for Responsible Investment. (https://www.unpri.org/about)

[5] Kenneth A. Bertsch, Executive Director, Council of Institutional Investors. Letter on "Concept Release: Business and Financial Disclosure Required by Regulation S-K." (July 8, 2016)

[6] Foreign regulators have been more proactive in requiring ESG disclosures. The European Union Council in Directive 2014/95/EU mandated ESG disclosures from its public entities, and Brazil, South Africa, and other countries have done so as well. The China Securities Regulatory Commission has introduced new requirements that mandate disclosure of ESG issues by 2020.

from nothing at all, to boilerplate, to disclosure with quantifiable metrics. Only 15% of ESG disclosures used metrics.[7] This "information asymmetry" can make it difficult for investors to assess long-term risk and firm value within and across industries. In addition, boilerplate risk identification can confuse the scope of risk and the likelihood that the risk will materialize. There is a need to establish SEC requirements to reduce boilerplate disclosure and harmonize human capital management reporting to support long-term investment and the efficient allocation of capital.

The lack of human capital management disclosure requirements is matched by the treatment of human capital spending under US Generally Accepted Accounting Principles (GAAP). Unlike significant physical investments, which are often capitalized, investments in human capital (and R&D investments) are expensed, as if increased worker capability were less useful to a company in successive quarters than a new building. At least R&D is disclosed on its own expenditure line—investors can assess company expenditures on R&D separately from other firm costs. Because human capital is included in administrative expenses, not as a stand-alone item, it is plausible that capital markets punish companies that invest in their workers as if those companies had excessive energy bills. Companies looking to meet quarterly earnings targets have an incentive to boost returns by underinvesting in human capital to bring down their administrative expenses, even though this will harm long-run productivity.[8]

The benefits of requiring increased human capital management disclosure are clear, and the costs are likely to be reasonable. Bernstein and Beeferman's study at Harvard Law School finds that a majority of companies in their dataset already collect a variety of human capital metrics of increasing interest to investors through their internal management processes. Requiring more disclosure on human capital management would not place an undue burden on public companies, given that many are already collecting—and some already disclosing—the relevant information.

I believe the addition of more human capital management disclosure requirements to Regulation S-K furthers the SEC's mission to "protect investors, maintain fair, orderly, and efficient markets, and facilitate capital formation." I urge the SEC to heed the calls for enhanced human capital management disclosure, exercise its rulemaking authority, and establish quantitative and qualitative requirements that promote comparability within and across industries.

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[7] Sustainability Accounting Standards Board, July 1, 2016. Comment on "Concept Release: Business and Financial Disclosure Required by Regulation S-K." (https://www.sec.gov/comments/s7-06-16/s70616-25.pdf)

[8] Angela Hanks, Ethan Gurwitz, Brendan V. Duke, and Andy Green. "Workers or Waste? How Companies Disclose – or Do Not Disclose – Human Capital Investments and What To Do About It." Report by the Center for American Progress. (2016)

Thank you for your consideration of our request and for your timely attention to these matters central to investor protection, the efficient allocation of capital, and long-term value creation.

Sincerely,

Mark R Warner

Mark R. Warner
United States Senator

cc: Commissioner Kara M. Stein
Commissioner Robert J. Jackson Jr.
Commissioner Hester M. Peirce