On the Compensation Committee's 2024 Agenda: Human Capital Updates

In recent years, in line with investors' rising interest in understanding companies' human capital practices, many compensation committees' remits expanded meaningfully to include a range of human capital matters, from oversight of employee engagement to measuring progress against human capital metrics contained in incentive plans, to name just two possibilities. This interest in human capital is driven in large part by a recognition that existing regulations are outdated, failing to align with the current reality that many companies now generate substantial value through internally cultivated intangible assets, prominently among them being human capital. Investor interest in these matters continues to grow, while at the same time increased politicization of and new legal complexities relating to human capital topics, particularly as they relate to diversity, equity and inclusion initiatives post-*Students For Fair Admissions, Inc. v. President and Fellows of Harvard College*, adds complexities for companies as they look forward to 2024 and beyond. Against this background, we share the following considerations with compensation committees as they look forward upon the somewhat opaque horizon.

QUANTITATIVE DISCLOSURES CONTINUE TO INCREASE, AND A NUMBER OF HCM METRICS MAY SOON BECOME MANDATED

Based on the SEC's current agenda – which slated human capital-related rulemaking for April 2024 – it may propose rule amendments to enhance required disclosures regarding human capital management any day now. This additional rulemaking follows the SEC's 2020 rulemaking, which provided for principles-based human capital disclosures that to date have largely failed to satisfy investors' desires for additional quantitative and qualitative information. Investors want this information both to provide better comparability between companies' practices and to better understand how companies prioritize their workforces. The SEC's Investor Advisory Committee's ("IAC") Investor-as-Owner Subcommittee's recommendations, published in September 2023, provide a strong indication of what disclosures might be mandated in the SEC's forthcoming rule proposal. These recommendations encourage mandated quantitative disclosures in four key areas.

IAC's Key Recommendations for Human Capital Management

Prescriptive Measures

1 Workforce Composition

Workforce composition in terms of full-time, part-time, and contingent workers

2 Employee Turnover

Metrics reflecting a company's employee turnover and workforce stability.

3 Workforce Cost

A breakdown of a company's workforce cost, detailing compensation components

4 Demographic Data

Demographic data about a company's workforce to assess talent access and development efforts.

Narrative Disclosure in MD&A

Additionally, the IAC suggests incorporating narrative disclosures in the Management Discussion & Analysis (MD&A) section of Form 10-K. This narrative would explain how labor practices, compensation incentives, and staffing align with the company's broader strategy, including the allocation of labor costs between growth-focused areas (e.g., research and development) and operations maintenance (e.g., compliance).

On the Compensation Committee's 2024 Agenda: Human Capital Updates (Continued)

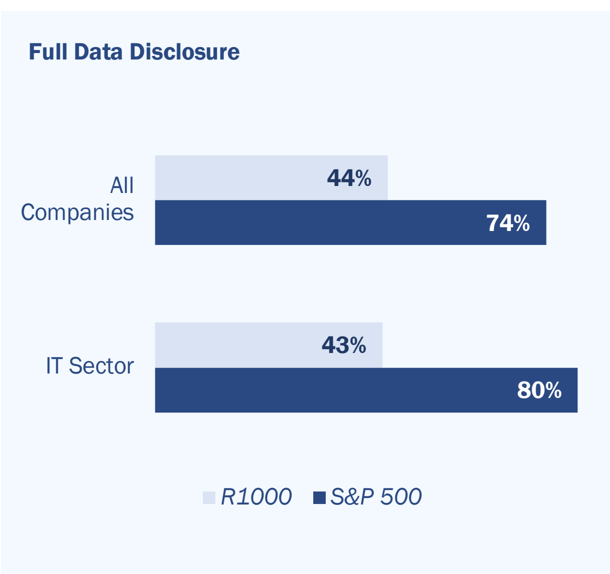
Timeline Of Recent Human Capital-Related Rulemaking

- **Mar 2019** — IAC urged SEC to enhance human capital disclosures for investors.
- **Aug 2020** — SEC updated Regulation S-K, requiring human capital risk and resource disclosure, adopting a flexible, principles-based approach.
- **Jun 2022** — The Working Group on Human Capital Accounting Disclosure petitioned the SEC for comprehensive human capital disclosure rules, including MD&A discussions, tabular compensation disclosures and disaggregated labor cost reporting.
- **Jul 2023** — FASB proposed disaggregation of employee compensation costs in income statements.
- **Sep 2023** — **IAC's Investor-as-Owner Subcommittee recommended detailed human capital disclosure, encompassing employee numbers, workforce stability metrics, cost breakdown, demographic data, and narrative MD&A disclosures.**

CURRENT STATE OF HCM DISCLOSURES

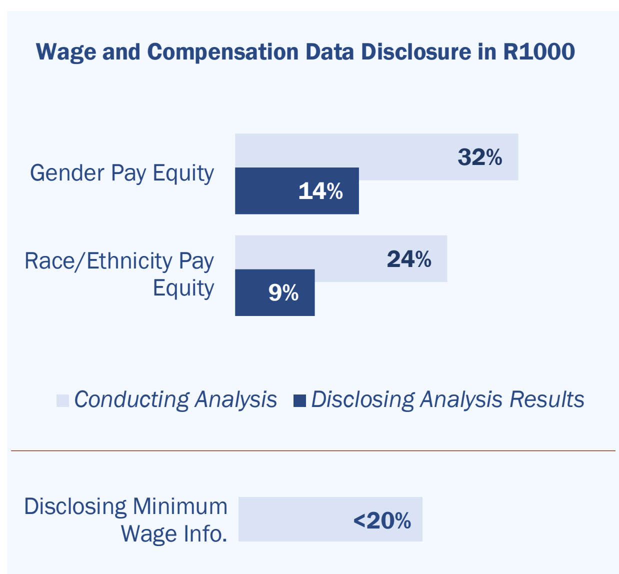
While disclosure of quantitative human capital metrics is not yet required, there is an evolving range of approaches taken by companies when it comes to these disclosures, with an evident trend towards enhanced transparency.

EEO-1 survey data disclosure in particular has proliferated in the past several years



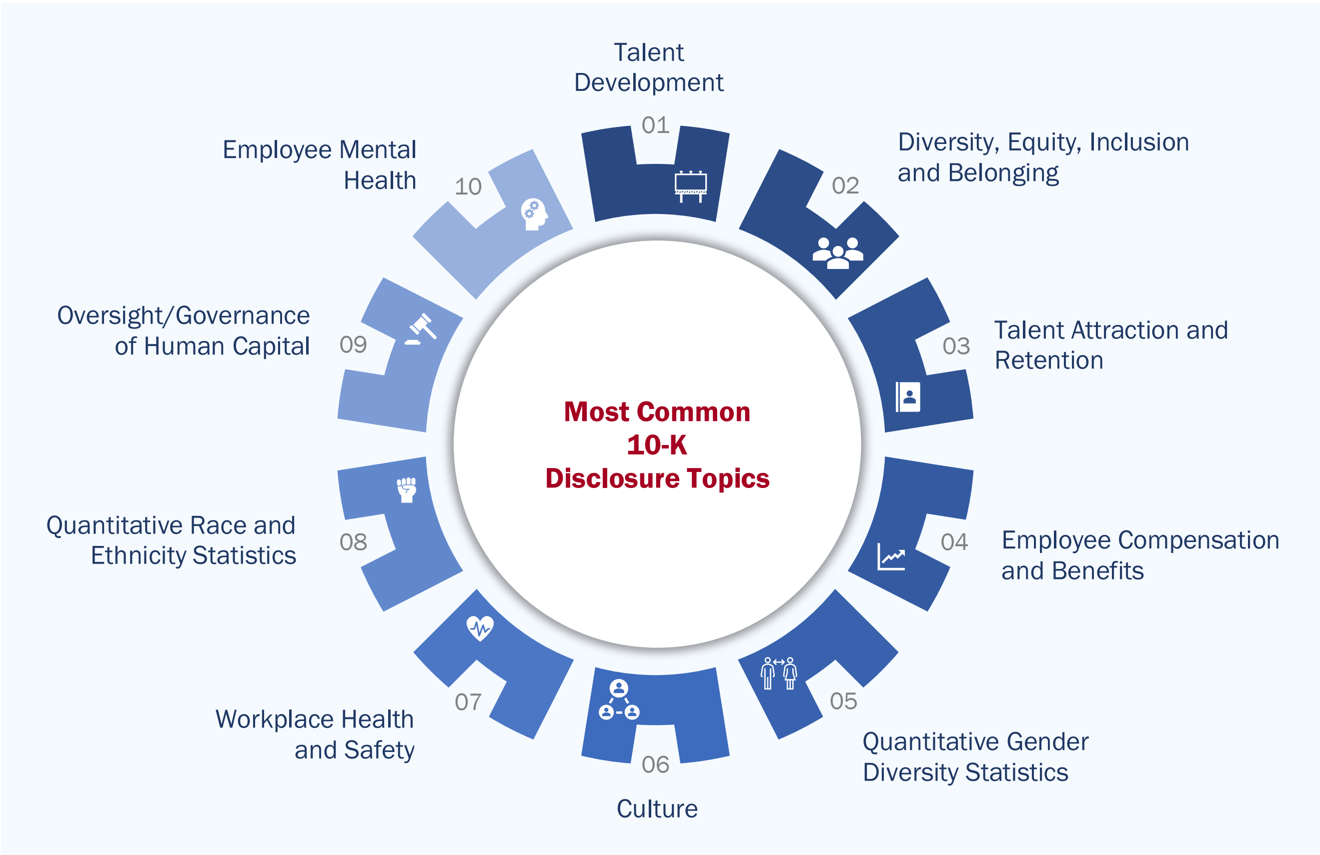
[Source: DiversIQ]

Wage and compensation data disclosure is increasing, but remains a minority practice



[Source: JustCapital]

On the Compensation Committee's 2024 Agenda: Human Capital Updates (Continued)



[Source: Gibson Dunn]

CONSIDER HUMAN CAPITAL METRICS IN THE CONTEXT OF INVESTORS' CURRENT EXPECTATIONS AND THE CURRENT POLITICAL CLIMATE

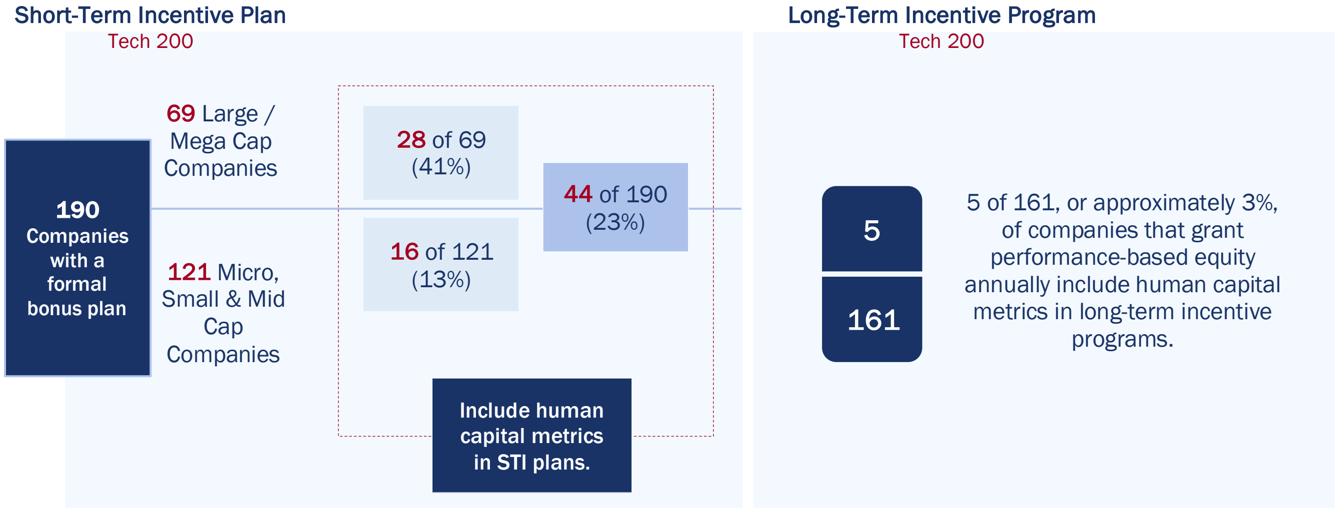
While investors' advocacy for human capital *disclosures* has not waned, their approach to human-capital related *metrics* in incentive compensation programs has evolved over the last few proxy seasons.

- Many major investors, including Vanguard and BlackRock have clarified that they do not necessarily advocate inclusion of these metrics at any cost. Instead, they should be assessed in the same light as any other metric in terms of rigor, strategic alignment, and measurability.
- European investors and those with high ESG integration, such as Amundi and Legal & General, tend to be more enthusiastic proponents of these metrics.
- Some, such as Dimensional, remain skeptical of the appropriateness of these metrics as key performance indicators.

Approaching human capital-related metrics, including DEI metrics, in the same manner as other traditional financial metrics should serve companies well in the current political climate. In the wake of *Students for Fair Admissions, Inc. v. President and Fellows of Harvard College*, it is also important to take a holistic approach to considering metric selection in a manner that ensures intentional alignment with broader operational and strategic goals and while avoiding constructs that could make a company more vulnerable to litigation. While companies generally are not considering changes to metrics in current plans, this shifting landscape is driving questions as to the need for go-forward changes to incentive measures or plan designs more broadly.

On the Compensation Committee's 2024 Agenda: Human Capital Updates (Continued)

USE OF HUMAN CAPITAL PERFORMANCE METRICS IN INCENTIVE COMPENSATION PROGRAMS



[Source: Compensia]

WHAT TO DO NOW

As companies contemplate their approach to human capital management in the near future, several actions may be helpful.

1. **Peer Benchmarking** - Examining peer practices is an informative starting point, but should not drive decision-making. While understanding how similar organizations are approaching HCM disclosures and metrics-setting can provide valuable insights into industry trends, a compensation committee's decision-making should be grounded in what is material to the company.

2. **Know your investors priorities** - Knowing the policy positions and engagement priorities of your significant investors is vital. Investors increasingly value transparency and enhanced HCM reporting, making it important to align disclosure practices with their specific expectations. For example, State Street is promoting the elevation of employee voice within both disclosures and compensation committee's oversight responsibilities. BlackRock for its part continues to advocate ISSB-aligned disclosures from all portfolio companies, which for many includes specific human capital topics. As for compensation metrics, strategic alignment (and clear communication to investors explaining both why the metric is important and how it is measured) is key. Knowing your investor expectations can both inform decision-making and avoid surprises when it comes to investor engagement and voting decisions.

3. **Prepare for data collection** - If you haven't already started, examine and adjust your data collection practices now in anticipation of forthcoming regulatory requirements. Preparing in advance for anticipated SEC rule changes (as well as workforce-related disclosures you may be required to disclose in the coming years pursuant to the EU CSRD) can avoid unnecessary surprises and provide committees with the opportunity to make incremental changes in advance of required disclosures.

4. **Determine the alignment between HCM disclosure and business strategy** - Examine your data to determine if your human capital practices align with your business strategy. For example, turnover data may reveal vulnerabilities to growth plans, or workforce costs that are not sustainable.

Ultimately, proactively preparing for these new disclosure requirements can help improve practices and processes and ensure your company is prepared to meet the rising expectations from key stakeholders, including employees, regulators, customers, and investors. In the evolving landscape of HCM disclosure and metric-setting, staying attuned to these considerations can position organizations for success and sustainability in the long run.

On the Compensation Committee's 2024 Agenda: Human Capital Updates (Continued)

NEED ASSISTANCE?

Compensia has extensive experience in helping companies analyze the requirements of the SEC's disclosure requirements. As we await the finalized disclosure requirements, we are happy to assist you prepare. If you would like assistance in preparing for the upcoming disclosure, or if you have any questions on the subjects addressed in this Thoughtful Pay Alert, please feel free to contact the authors of this Alert.

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