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United States House of Representatives
Committee on Financial Services
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December 1, 2022

Memorandum

To: Members, Committee on Financial Services
From: FSC Majority Staff and Subcommittee Chair Brad Sherman
Subject: December 6, 2022, Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets Hearing entitled, "E, S, G and W: Examining Private Sector Disclosure of Workforce Management, Investment, and Diversity Data"

The Subcommittee on Investor Protection, Entrepreneurship, and Capital Markets will hold a hearing entitled, "E, S, G and W: Examining Private Sector Disclosure of Workforce Management, Investment, and Diversity Data" on Tuesday, December 6, at 2:00 pm in room 2128 of the Rayburn House Office Building/ Cisco Webex. There will be one panel with the following witnesses:

- **Cambria Allen-Ratzlaff**, Managing Director and Head of Investor Strategies, JUST Capital
- **Colleen Honigsberg,** Ph.D. in Accounting and Professor of Law, Stanford Law School
- **Shivaram Rajgopal**, Ph.D. in Accounting and Professor of Accounting and Auditing, Columbia Business School
- **Fran Seegull**, President, U.S. Impact Investing Alliance
- **Andy Vollmer**, Senior Affiliated Scholar and former SEC Deputy General Counsel, Mercatus Center

Overview

Under the Securities Exchange Act of 1934, the Securities and Exchange Commission (SEC) requires public companies to file annual (Form 10-K) and quarterly (Form 10-Q) reports with the Commission to publicly disclose company information that investors would find pertinent in making investment decisions.[1] This reporting requirement mandates the disclosure of an audited income statement and balance sheet, information related to risk exposure, material financial data, and an analysis performed by management on the company's financial condition.[2] In recent years, investors in publicly traded companies and investment funds have begun to request increased disclosure of standardized and reliable data regarding environmental, social and governance (ESG) related factors.[3] Many investors also want standardized and reliable numerical information about a company's workforce; for most companies, its workforce is its most important asset. ESG criteria constitute a measurable way to assess a company's efforts to manage those risks and to hold companies accountable. While publicly traded companies must disclose "material" and other information under federal securities laws, current SEC requirements are fairly limited in terms of express ESG disclosures.[4]

The SEC has, however, begun to take steps to establish explicit ESG disclosure requirements. In August of 2020, the Commission, under the leadership of Chair Clayton, adopted amendments to Regulation S-K to require public companies to include in their annual Form 10-K filings "a description of the registrant's human capital resources to the extent such disclosures would be material to an

[1] *See* 15 U.S.C. § 78m(a).
[2] SEC, Form 10-K, General Instructions (accessed Nov. 28, 2022).
[3] SEC, Speech by Commissioner Jaime Lizárraga entitled Meeting Investor Demand for High Quality ESG Data (Oct. 17, 2022).
[4] SEC, The Laws That Govern the Securities Industry, (accessed Nov. 28, 2022).

understanding of the registrant's business."[5] In May 2021, SEC Chair Gary Gensler confirmed that agency staff have been developing enhanced climate-related and "human capital management" disclosures.[6]

Relatedly, in March of 2021, the Commission voted to release for public comment a proposed rule to require public companies to make a variety of specific disclosures regarding climate-related risks likely to have a material impact on their business.[7] Among these requirements, public companies would be required to disclose specific greenhouse gas (GHG) emission data.[8] The SEC also recently moved to issue proposed rules which would require certain investment advisers and funds which hold themselves out as pursuing ESG investment objectives to make detailed disclosures explaining those ESG investment considerations.[9]

Human Capital Management Disclosures

According to surveys of public company executives, 71 percent of CEOs identified human capital as one of the most important sources of economic value within their companies.[10] However, despite the 2020 amendments to Regulation S-K, the current SEC disclosure framework does not require public companies to provide investors with uniform metrics regarding their management of and investment in their employees. How a company invests in its workforce can affect the long-term value of the company. For example, if a company consistently has a high rate of workforce turnover, it may struggle to compete long-term. [11]

In 2017, a global group of 26 institutional investors representing over $3 trillion in assets, submitted a rulemaking petition to the SEC urging the adoption of standards that would require listed companies to disclose information on human capital management policies, practices, and performance. The petition also includes many of the recommendations the SEC's Investor Advisory Committee adopted on March 28, 2019.[12] At a hearing before the House Appropriations Committee in April 2018, former SEC Chairman Jay Clayton, who was appointed by former President Trump, emphasized the importance of this information to investors and stated that he "would like to see more disclosure from public companies on how they think about human capital."[13]

Workforce Management and Investment

Since 1998, firms in the European Union have been required to report total human capital investments in relation to salaries, bonuses, and other benefits, but because similar disclosures are not required and are thus only voluntary in the U.S., only 15% of S&P 500 firms do so.[14,15] However, according to the Embankment Project for Inclusive Capitalism (EPIC), those U.S. companies that

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[5] SEC, Press Release: "SEC Adopts Rule Amendments to Modernize Disclosures of Business, Legal Proceedings, and Risk Factors Under Regulation S-K," (Aug. 26, 2020).
[6] SEC Chair Gary Gensler, "Testimony Before the House Appropriations Committee for the Securities and Exchange Commission Oversight Hearing," (May 26, 2021).
[7] SEC, Press Release: "SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors," (Mar. 21, 2022).
[8] *Id.*
[9] SEC, Press Release: "SEC Proposes to Enhance Disclosures by Certain Investment Advisers and Investment Companies About ESG Investment Practices," (May 25, 2022).
[10] IBM, *The Value of Training: IBM Training building skills for a smarter planet*, (May 2014).
[11] Houston Chronicle Small Business Section, *The Negative Impacts of a High Turnover Rate*, (Feb. 4, 2019).
[12] SEC Investor Advisory Committee, Recommendation from the Investor-as-Owner Subcommittee on Human Capital Management, (Mar. 19, 2019).
[13] FY 2019 Budget-U.S. Securities and Exchange Commission, Hearing Before the H. Comm on Appropriations, 115th Cong. (2018) (statement of Jay Clayton, Chairman, Securities and Exchange Commission).
[14] *International Accounting Standards Rule 19*, Employee Benefits.
[15] U.S. Securities and Exchange Commission, Letter from Dr. Anthony Hesketh, Professor, Lancaster University, to Anne Sheehan, Chairwoman, Investor Advisory Committee (Mar. 21, 2019).

voluntarily disclose this information outperform those that do not and receive better returns on their investment in human capital.[16]

The Working Group on Human Capital (WGHC) Accounting Disclosure recently sent a letter to the SEC urging Chair Gensler to quickly adopt a rule to broaden and codify workforce (or Human Capital) disclosures.[17] Currently, workforce expenditures, including salaries, training and etc., are accounted as ordinary expenses instead of specifically identified expenses like research and development (R&D). The WGHC maintains investors need better workforce disclosures to better value companies, especially those, like tech companies, that are losing money but have possible future value. Hiring talent and investing in a company's workforce can be seen as an intangible asset but it is not disaggregated from expenses or separately disclosed for investor review.[18]

Diversity in the C-Suite and in the Corporate Workforce

According to a recent analysis of the boards of the 3,000 largest publicly traded companies, just 12.5 percent of board directors come from underrepresented ethnic and racial groups, despite making up 40 percent of the U.S. population.[19] This analysis also found that African Americans make up just 4 percent, and African American women only 1.5 percent, of the individual board directors included in the review.[20] The SEC recently approved a "comply or explain" rule regarding corporate board diversity for all companies listed on the NASDAQ stock exchange. This raises the question of whether this requirement should be applied to companies listed on other exchanges. Research suggest that diverse boards lead to improved financial results, indeed companies with the highest percentages of women board directors outperformed those with the least by 53% when it comes to return on equity.[21]

Furthermore, company leadership that does not take advantage of the potential profitability associated with having a diverse and inclusive workforce and culture may be subjecting the company to financial, reputational, and in some cases, litigation risk. A September 2020 Business Reporter article noted that, "Boards with only a token attempt at diversity and inclusion, who practice 'one and done', are unlikely to convince stakeholders that they are really making an effort. They may well damage the company's reputation, especially in the eyes of investors looking for exemplary corporate governance practice."[22]

A company that lacks diversity or does not make diversity, equity, and inclusion a priority may also damage its reputation with potential employees, especially younger, more diverse candidates. In February 2021, the Washington Post reported that many younger job seekers—those born in the Millennial and Gen Z generations—see D&I as a workplace requirement and may choose not to work for companies that lack workforce diversity or that are not making commitments to address the issue of systemic racism.[23] Glassdoor's 2020 D&I workplace survey noted that job seekers and employees from historically underrepresented groups—about 4 in 5 Black, Hispanic, and LGBTQ respondents— reported that "a diverse workforce is an important factor when evaluating companies and job offers."[24] According to

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[16] *Id.*
[17] Working Group on Human Capital Accounting, Disclosure Petition for Rulemaking, (Jun. 7, 2022).
[18] *Id.* at 4.
[19] New York Times, *Diversity Push Barely Budges Corporate Boards to 12.5%, Survey Finds,* (Sep. 15, 2020).
[20] *Id.*
[21] BoardReady, Lessons from the Pandemic: Board Diversity and Performance, (Jul. 13, 2021).
[22] David Doughty, "Diversity and inclusion: what's the risk?" Business Reporter, September 18, 2020, https://business-reporter.co.uk/fraud-prevention-and-risk-management/#slide5.
[23] Jennifer Miller, "For younger job seekers, diversity and inclusion in the workplace aren't a preference. They're a requirement," Washington Post, Feb. 18, 2021, https://www.washingtonpost.com/business/2021/02/18/millennial-genz-workplace-diversity-equity-inclusion/.
[24] Glassdoor Team, "Glassdoor's Diversity and Inclusion Workplace Survey," Glassdoor, September 30, 2020, https://www.glassdoor.com/blog/glassdoors-diversity-and-inclusion-workplace-survey/.

McKinsey, both women and men are happier and plan to stay at their company for longer when they believe their company is “highly committed to gender diversity.”[25] Given the risk of future talent gaps, business risk professionals have advised that diversity for investors is no longer simply just “nice to have, but a must have to manage the risks associated with their forecasted talent gap.”[26]

Investors are often factoring D&I into their investment decisions and increasingly expecting this information to be disclosed to them and to the public. One investment company noted that portfolio managers and analysts in their firm are using diversity statistics as a measure of their ability to contribute positive returns to their portfolio.[27] A June 2019 Industry Week article also noted that “the disclosure of workplace equity data is increasing in its importance to investors and they are letting companies know that this information is material to investment decisions.”[28] Particularly in the aftermath of George Floyd’s death and widespread protests sparking consciousness on systemic racism, investors are assessing the extent to which companies are making real commitments to racial equity.[29]

Climate-Related Disclosures

Climate change poses a fundamental threat to America’s financial eco-system, its businesses, and to the global economy.[30] In 2021, the Federal Reserve Bank of San Francisco published an economic letter finding that “the ongoing trend of climate change—including higher temperatures and more extreme weather—will result in economic and financial losses for many businesses” and that “such climate-related financial risk may threaten the safety and soundness of individual financial institutions and the stability of the overall financial system.”[31] This stability may be threatened either by financial stress from a single financial institution or stress experienced by a number of small correlated financial institutions.[32] Importantly, the impact of climate change is not limited the U.S. economy. A 2020 Oxford Economics study found that “more than 20% of global gross domestic product will be at risk by 2100” due to the impacts of climate change.[33]

There is growing evidence that climate change risk, as well as other ESG disclosures, are material to investors. As an initial matter, climate change and ESG factors affect a company’s profitability. For instance, the Carbon Disclosure Project—a coalition of bankers, fund managers, advocacy groups, and politicians— issued a 2019 report that found climate change will cost the 215 largest listed companies nearly $1 trillion over the next five years alone.[34] Additionally, research suggests that climate change, “if left unmanaged, could cost the world’s financial sector between $1.7 trillion to $24.2 trillion in net present value terms.[35] Further, many investors view ESG information as important not just for evaluating reputational risks, but for evaluating companies’ financial performance as well as long-term viability.[36]

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[25] Sarah Coury et. al, “Women in the Workplace 2020,” McKinsey & Company, September 30, 2020, https://www.mckinsey.com/featured-insights/diversity-and-inclusion/women-in-the-workplace.
[26] Sonya Sepahban, “Lack of Diversity is Risky Business according to Business Risk Professionals,” OurOffice, September 10, 2019, https://www.ouroffice.io/2019/09/10/lack-of-diversity-is-risky-business-according-to-business-risk-professionals/.
[27] Maggie Sullivan, “Why Diversity Should Matter to Investors,” Ellevate, accessed Mar. 7, 2021, https://www.ellevatenetwork.com/articles/9994-why-diversity-should-matter-to-invesommtors.
[28] Industry Week Staff, “Investors Representing $1.61 Trillion in Assets Tell Companies to Disclose Workplace Equity Data,” Industry Week, June 19, 2019.
[29] Alan Fleischmann, “Turning ‘ESG’ into ‘ESGD’: How investors can support diversity with their dollars,” Fortune, June 11, 2020, https://fortune.com/2020/06/11/diversity-inclusion-investing-esg-esgd/.
[30] Commodities Futures Trading Commission, Managing Climate Risk in the U.S. Financial System, (accessed Nov. 27, 2022).
[31] Federal Reserve Bank of San Francisco, Climate Change is A Source of Financial Risk, (Feb. 8, 2021).
[32] Center for American Progress, Climate Change Threatens the Stability of the Financial System, (Nov. 20, 2019).
[33] Global Financial Markets Association, Climate Finance Markets and the Real Economy, (Dec. 2020).
[34] Reuters, *World’s Biggest Firms Foresee $1 trillion Climate Cost Hit,* (Jun. 4, 2019).
[35] New York Times, *Companies See Climate Change Hitting Their Bottom Lines in the Next 5 Years,* (Jun. 4, 2019).
[36] *See* e.g., Bank of America, ESG: Good Companies Can Make Good Stocks, at 1 (December 18, 2016) (finding that “[ESG] metrics have been strong indicators of future volatility, earnings risk, price declines and bankruptcies.”); Nordea, Cracking the ESG Code, at 1

In a 2015 report, Blackrock Investment explained that "[c]ompanies that score high on ESG measures tend to quickly adapt to changing environmental and social trends, use resources efficiently, have engaged (and, therefore, productive) employees, and face lower risks of regulatory fines or reputational damage."[37] The credit rating agencies also now incorporate ESG factors into their ratings methodologies. For instance, Standard & Poor's has taken over 100 rating actions based on environmental and climate concerns.[38]

In response to growing investor demand for climate-related risk disclosures, as noted above, SEC issued a proposed rule earlier this year that would require public companies to make a number of new quantitative and qualitative disclosures in their annual public filings. Under the proposed requirements, companies would need to provide investors with a description of its climate-related risks and relevant risk management processes, as well as an explanation of how the identified climate-related risks have had or are likely to have a material impact on its business and financial statements during the short, medium, or long term.[39] A primary focus of the proposal has been requirements for firms to disclose direct and indirect GHG emissions produced as a result of its business activities.[40] Under the framework, the volume GHG emissions required to be disclosed are broken into three distinct categories referred to as Scopes 1, 2, and 3. Under the proposed rule, information about a firm's "direct greenhouse gas (GHG) emissions (Scope 1) and indirect emissions from purchased electricity or other forms of energy (Scope 2), … [and] a registrant would be required to disclose GHG emissions from upstream and downstream activities [that the company buys from, sells to, or finances] in its value chain (Scope 3), if material or if the registrant has set a GHG emissions target or goal that includes Scope 3 emissions."[41]

(September 5, 2017) ("Companies that score higher on ESG demonstrate better operational performance, with regards to both the level and the stability of returns.").

[37] Blackrock Investment Institute, The Price of Climate Change: Global Warming's Impact on Portfolios, (Oct. 31, 2015).

[38] Standard & Poor's, How Does S&P Global Ratings Incorporate Environmental, Social, and Governance Risks Into Its Ratings Analysis, (Nov. 21, 2017).

[39] SEC, Press Release: "SEC Proposes Rules to Enhance and Standardize Climate-Related Disclosures for Investors," (Mar. 21, 2022).

[40] *Id.*

[41] *Id.*

Appendix

Legislation

- **H.R.1188, "Greater Accountability in Pay Act of 2021" (Velazquez).** This bill would require public companies to disclose the pay raise percentage of its executives and the pay raise percentage of its median employee over the past year and compare each to the rate of inflation, and would require public companies to disclose the ration between the two pay raise percentages.

- **H.R.1277, "Improving Corporate Governance Through Diversity Act of 2021" (Meeks).** This bill would require public companies to disclose racial, ethnic, and gender compositions of their boards of directions and executive officers, and veteran status. This bill would also require covered companies to disclose any plan to promote diversity and requires the Securities and Exchange Commission to establish a Diversity Advisory Group.

  H.R.1780, "Paris Climate Agreement Disclosure Act" (Velazquez). This bill would require covered issuers to disclose the steps they are taking to be in compliance with the requirements set forth in the Paris Climate Agreement, including whether the issuer has set or committee to achieve targets that are a balance between greenhouse gas emissions and removals at a pace consistent with limiting global warming to below 2 degrees Celsius.

- **H.R.3007, "Disclosure of Tax Havens and Offshoring Act" (Axne).** This bill would require certain issuers of securities to annually disclose information related to the tax jurisdiction, income, and assets of their constituent entities on a country-by-country basis.

- **H.R.3471, "Workforce Investment Disclosure Act of 2021**" **(Axne).** This bill requires publicly traded companies to disclose information annually regarding workforce management policies, practices, and performance.

- **H.R.2123, "Diversity and Inclusion Data Accountability and Transparency Act" (Beatty).** This bill makes reporting requirements under Section 342 of the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010 mandatory. Under the draft bill, regulated entities, including publicly traded companies and investment firms, would be required to disclose their diversity policies and practices to their respective regulators.

- **H.R.___, "Diverse Investment Advisers Act" (Beatty).** This draft bill would require companies that register and are registered with the SEC to consider at least one diverse asset manager when contracting out for asset management services and report to the SEC on the extent to which they use diverse asset managers.