CAN THE SEC MANDATE DISCLOSURES THAT CONTAIN BOTH FINANCIAL AND SOCIAL INFORMATION? THE CASE OF HUMAN CAPITAL MANAGEMENT DISCLOSURES

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Human capital contributes directly to the top and bottom line of corporate financial performance. However, theory predicts, and empirical studies suggest, that firms underinvest in human capital because of a classic public goods problem: since employees can always leave to work for another employer, firms cannot expect to bear all the fruits of investments they make in human capital. As human capital becomes more important in the modern service and technology economy, the ills of this public good problem are growing and the deficiencies of underinvestment becoming more apparent.

This Article studies the potential role of human capital management disclosures. Sophisticated investors ask for human capital disclosures in private offerings, negotiated mergers and acquisitions, and in periodic public company disclosures. But the empirical analysis in this Article shows that voluntary disclosures by public companies in periodic reports filed with the Securities and Exchange Commission (SEC) lack critical human capital management information and are fragmented, inconsistent, and incomparable. The Article explains why new prescriptive, mandatory human capital management disclosures for public companies can improve investment decisions, voting decisions in director elections, and investor stewardship activities.

The human capital management case study shows why the SEC's statutory authority must be interpreted as broad enough to compel disclosures that contain an inextricable nexus with social issues, so long as the disclosures produce at least some business or financial information. It is unlikely that any standard that gives judges broader ability to second-guess

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the SEC on the boundaries of the information package mandated by the federal securities laws would be consistent with the statutory text granting the SEC's broad authority to compel disclosures that are "necessary or appropriate" for the protection of investors or in the public interest.

The Article weighs arguments in favor of approval of a mandatory prescriptive human capital management disclosure rule that is more consistent with the needs of investors and the objectives of the securities laws.

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INTRODUCTION

Many investors, entrepreneurs, and corporate stakeholders have started asking questions about how they can privately order their affairs in ways that take into account the externalities of corporate production.[1] By externalities, I mean unpriced benefits and costs to third parties, like harmful pollutants emitted by a factory.[2] Professor Dorff's book provides a seminal and comprehensive account of some of the organizational law aspects of this

1. *See* Oliver Hart & Luigi Zingales, *Companies Should Maximize Shareholder Welfare Not Market Value*, 2 J. L. FIN. & ACCT. 247 (2017); David Kershaw & Edmund Schuster, *The Purposive Transformation of Corporate Law*, 69 AM. J. COMPAR. L. 478 (2021) (arguing that corporate law must enable companies to construct a zone of insulation which protects its purpose from the pressures of immediate shareholder preferences which can compromise mission-purpose); Ofer Eldar, *The Role of Social Enterprise and Hybrid Organizations*, 2017 COLUM. BUS. L. REV. 92 [hereinafter *Role of Social Enterprise*] (arguing that pro-social corporations have a function of measuring some information about the customers with which they transact); Ofer Eldar, *Designing Business Forms to Pursue Social Goals*, 106 VA. L. REV. 937 (2020) (analyzing mechanisms that can certify an entity's social activities); Robert P. Bartlett, III & Ryan Bubb, *Corporate Social Responsibility Through Shareholder Governance*, 97 S. CAL. L. REV. 417 (2024); Alessio M. Pacces, *Controlling Shareholders and Sustainable Corporate Governance: : The Role of Dual-Class Shares*, 25 THEORETICAL INQUIRIES L. 43 (2024); Gregory H. Shill, *The Social Costs (and Benefits) of Dual-Class Stock*, 75 ALA. L. REV. 221 (2023); Emilie Aguirre, *The Social Benefits of Control*, 74 DUKE L.J. 2 (forthcoming June 2024); Jill E. Fisch & Steven Davidoff Solomon, *Should Corporations Have a Purpose?* 99 TEX. L. REV. 1309 (2021); Edward B. Rock, *For Whom is the Corporation Managed in 2020? The Debate Over Corporate Purpose*, 76 BUS. LAW. 363 (2021); Quinn Curtis, Jill Fisch & Adriana Z. Robertson, *Do ESG Funds Deliver on Their Promises?*, 120 MICH. L. REV. 393, 395 (2021); Michal Barzuza et al., *Shareholder Value(s): Index Fund ESG Activism and the New Millennial Corporate Governance*, 93 S. CAL. L. REV. 1243 (2020); Patrick M. Corrigan, The Corporate Governance Trilemma (Apr. 1, 2024) (working paper), https://ssrn.com/abstract=4729606; Wolf-Georg Ringe, *Investor-Led Sustainability in Corporate Governance*, 7 ANN. CORP. GOVERNANCE 93, 95 (2022); Patrick M. Corrigan, *The Institutional Turn in Corporate Governance Towards Addressing Corporate Externalities and Public Goods*, *in* LAW AND ECONOMICS OF JUSTICE: EFFICIENCY, RECIPROCITY, MERITOCRACY (Klaus Matthis & Avishalom Tor, eds., 2024).

2. *See* RICHARD CORNES & TODD SANDLER, THE THEORY OF EXTERNALITIES, PUBLIC GOODS, AND CLUB GOODS 39 (2d ed., 1996).

private ordering challenge.[3] In this Article, I focus on a specific application of a different legal framework that affects economic coordination and private ordering: mandatory disclosure rules. More specifically, I study the question of mandatory disclosure rules with respect to the issue of corporate investments in the human capital of workers. Human capital management is a systematic issue of major concern to public investors and has recently become a focus of disclosure proposals.[4]

Federal securities law creates a system of mandatory disclosures.[5] But the governing statutes leave open a critical question: what is the precise package of information required to be disclosed? Recently, this source of ambiguity has led to another question: does the Securities and Exchange Commission (SEC) have statutory authority to require disclosures that produce mixed information that inextricably bears on both financial and social issues?

Four decades ago, Professor John Coffee made a seminal argument justifying the mandatory disclosure system in the U.S. securities laws.[6] Because third parties can free-ride on securities information, securities research tends to be underprovided—a classic public goods problem. Collectively, all investors would be better off with more securities research, but no individual has incentives to incur the costs necessary to produce the optimal amount. A regulatory scheme that requires mandatory disclosures by issuers increases securities research, places disclosure obligations on the lowest-cost provider, minimizes transaction costs, and reduces wasteful, duplicative research by dispersed investors.

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3. MICHAEL B. DORFF, BECOMING A PUBLIC BENEFIT CORPORATION: EXPRESS YOUR VALUES, ENERGIZE STAKEHOLDERS, MAKE THE WORLD A BETTER PLACE (2024); *see* Dana Brakman Reiser & Anne Tucker, Buyer Beware: Variation and Opacity in ESG and ESG Index Funds, 41 CARDOZO L. REV. 1921, 1992 (2020); Baruza et al., *supra* note 1.

4. Jeffrey N. Gordon, *Systematic Stewardship*, 47 J. CORP. L. 627 (2022). On the policy relevance of these proposals, *see, e.g.*, George S. Georgiev, *The Human Capital Management Movement in U.S. Corporate Law*, 95 TUL. L. REV. 639, 646 (2021) [hereinafter *Human Capital Management Movement*].

5. In this Article, I focus on the mandatory disclosure requirements under the Securities and Exchange Act of 1934 Section 12 and 13(a)(1). Securities and Exchange Act of 1934, 15 U.S.C. §§ 78l–78m(a)(1). In this Article, I focus on the mandatory disclosure requirements under the Securities and Exchange Act of 1934 Section 12 and 13(a)(1). Securities and Exchange Act of 1934, 15 U.S.C. §§ 78l–78m(a)(1). The Securities Act of 1933 also imposes mandatory disclosures on companies that engage in certain public offerings of securities. 15 U.S.C. § 77a et seq.

6. John C. Coffee, Jr., *Market Failure and the Economic Case for a Mandatory Disclosure System*, 70 VA. L. REV. 717 (1984); *see also* Merritt B. Fox, *Retaining Mandatory Securities Disclosure: Why Issuer Choice Is Not Investor Empowerment*, 85 VA. L. REV. 1335, 1339 (1999); Patrick M. Corrigan, *Do the Securities Laws Protect Investors (and How)? Lessons from SPACs*, 101 WASH. U. L. REV. 1123, 1153 (2024).

Recently, new battle lines have been drawn around the *boundaries* of the information package required under the mandatory disclosure system. Three lines have received particular attention. First, a live debate exists about whether the SEC can and should compel disclosures that generate *mixed* information with both financial and nonfinancial implications, including certain environmental, social, and governance (ESG) information.[7] Second, to the extent that the SEC does compel ESG disclosures, should it compel prescriptive disclosures or more general principles-based disclosures? Finally, and relatedly, is the question of whether ESG disclosures should only be mandatory if the underlying information is material to investors.

In this Article, I advance an argument for mandatory prescriptive human capital management disclosures from a public good and market failure perspective. I argue, first, that human capital is important to the financial performance of firms but it is itself a public good that is underprovided by markets. Because firms can poach employees from competitor firms, employers contemplating human capital investments cannot guarantee they will bear all the fruits of their investment. This tends to reduce human capital investment overall. Because of the unique features of labor, existing legal solutions are unable to address the public good problem posed by human capital. Moreover, information about this primary market failure—underinvestment in human capital—is itself underprovided by the market because securities research is also a public good. Human capital management disclosures, thus, present a public goods problem nested in a public goods problem.

Section II.B.1 empirically documents that voluntary disclosures by public companies produce inadequate public information about human capital management. A primary result of the empirical analysis is that almost no companies among the forty-five in my sample voluntarily disclose the information thought to be most important by leading human capital management disclosure proposals, including detailed, disaggregated information about human capital costs and investments. Disclosures are inconsistent, incomparable, and fragmented. These results are robust across large capitalization companies, small capitalization companies, and companies incorporated with the purpose of advancing a public benefit. Section II.B.2 presents an analysis suggesting that many of the existing voluntary disclosures of human capital management do not appear to be driven primarily by values of managers or by the fixed costs of disclosures. The empirical results are consistent with a growing body of evidence

7. *See, e.g.*, Madison Condon, *What's Scope 3 Good for?*, 56 U.C. DAVIS L. REV. 1921 (2023).

suggesting that voluntary ESG disclosures contain large amounts of boilerplate language, lack specificity, and are overall inconsistent and incomparable across firms.[8] Concerns about "greenwashing"—false or misleading environmental or social disclosures primarily made for the purpose of public relations—abound.[9] In short, existing voluntary human capital management disclosures are inadequate.

Part III sets forth the case for using prescriptive, mandatory human capital disclosures to advance the goals of the securities laws.[10] Section III.A constructs an analytical benchmark against which to evaluate the optimal level of disclosure about human capital management issues—the perspective of large "universal owners."[11] Sections III.B and III.C explain why mandatory human capital proposals would help investors price securities when making investment decisions, vote in director elections, respond to proxy solicitations, and engage managers. By providing key information and by producing standardized and comparable information, a mandatory disclosure rule can help to bridge the information asymmetries, hold-up problems, valuation challenges, and engagement challenges that plague investor valuation and stewardship related to human capital matters.[12]

Recently, ESG disclosure proposals have come under attack, especially the SEC's climate disclosure rule, which is voluntarily stayed pending litigation challenges.[13] It remains to be seen whether the climate disclosure rule litigation will have relevance after the election of Donald Trump in November 2024, but the disputed issues underlying the litigation will undoubtedly resurface in the future. Given its nexus with social issues—including diversity, unions, wages, and other labor issues—similar challenges could be brought against a proposed human capital management

8. Yan Lin et al., *Global Evolution of Environmental and Social Disclosure in Annual Reports*, J. ACCT. RSCH. (forthcoming 2024); Amanda M. Rose, *A Response to Calls for SEC-Mandated ESG Disclosure*, 98 WASH. U. L. REV. 1821 (2021); *see also* Scott Hirst, *Saving Climate Disclosure*, 28 STAN. J.L., BUS. & FIN. 91 (2023) (claiming that ESG performance ratings are inconsistent and difficult to decipher).

9. Barbara Ballan & Jason J. Czarnezki, *Disclosure, Greenwashing, and the Future of ESG Litigation*, 81 WASH. & LEE L. REV. 545 (2024).

10. A rule passed by the SEC in 2020 requires certain principles-based human capital management disclosures, but only if the issuer determines the information meets a materiality test. *See infra* note 65. The principles-based rule leaves issuers with considerable discretion in what to disclose and how to disclose it. *See infra* notes 64-71 and accompanying text. In contrast, a prescriptive approach would specify certain metrics and other types of information that must be disclosed and the manner in which it must be disclosed.

11. I use the term "universal owners" generally to mean large institutional investors that invest in a diversified portfolio of securities issued by many companies.

12. *See infra* Part III.

13. Consol. Brief of State Petitioners, Iowa v. SEC, No. 24-1522 (8th Cir. June 21, 2024); *see also infra* note 138 and accompanying text.

disclosure rule. Does the SEC have statutory authority to promulgate a mandatory human capital management disclosure rule?[14]

Critics of the SEC's climate disclosure rule claim that the rule violates subject matter restrictions on the SEC's statutory disclosure authority. They argue that the SEC cannot compel disclosures of information with mixed financial and social implications because the SEC's disclosure authority is limited to the realm of financial information.[15] On one end of the spectrum, no one disputes that the SEC can mandate information solely about the firm's business and financial performance, such as earnings results. On the other end, no one claims that the SEC can mandate disclosure rules that are solely social in nature, such as the political opinions of managers. But what about disclosures of information somewhere in between that contain mixed financial and social relevance? Human capital management disclosures touch on contested social issues, but also undoubtedly implicate issues of financial and operating performance.

Any precedent set in the Eighth Circuit on the climate disclosure rule, or in future litigation on similar issues, will have important consequences for the system of mandatory disclosures under the securities laws. If reviewing courts rule that the SEC lacks statutory authority to mandate the mixed information in the climate disclosure rule, that precedent may make it impossible for the SEC to promulgate a prescriptive human capital management rule in the future. Existing disclosure rules that generate mixed information, including rules related to executive compensation and material contracts, would be vulnerable to challenge. Such a precedent could seriously undermine the effectiveness of the seamless system of mandatory disclosures implemented by Congress in 1934 as amended from time to time.

One broad lesson of the human capital management case study is that adherence to a textualist method of statutory interpretation compels the conclusion that the SEC's statutory authority must be interpreted broadly enough to include disclosure mandates that produce mixed financial and nonfinancial information. When it enacted the Securities Exchange Act of 1934, Congress delegated broad authority to the SEC to safeguard investors and protect the integrity of the exchanges.[16] Central to Congress's statutory design was its extension to the SEC of two independent grants of rulemaking

14. In this Article, I only consider the question of statutory authority. I do not consider constitutional challenges to proposed rules or challenges related to the major questions doctrine.

15. *See, e.g.*, Consol. Brief of State Petitioners, *supra* note 13; Comment Letter from Lawrence A. Cunningham, Professor of L., George Wash. Univ., on Behalf of Twenty-Two Professors of Law and Finance to the SEC (Apr. 25, 2022) [hereinafter Cunningham Letter], https://www.sec.gov/comments/s7-10-22/s71022-20126528-287180.pdf.

16. Sec. and Exch. Comm'n, *Statutes and Regulations*, https://www.sec.gov/rules-regulations/statutes-regulations (last updated Oct. 1, 2013); *see infra* notes 114-116.

authority, giving the SEC the ability to require "such other information" as it deems "necessary or appropriate" in the "public interest" or "for the protection of investors."[17] Under a *Loper Bright* textual analysis, the best reading of the Exchange Act—and particularly the "necessary or appropriate" language—is that Congress delegated broad discretion to the SEC when it enacted the statute in 1934, and through custom and tradition in the years since, to determine the boundaries of the information package required by mandatory disclosures.[18]

Given this broad textual authority, here is the legal standard I would propose for reviewing the SEC's statutory authority: if a disclosure rule rationally relates to commercial, financial, or business information and does not affect corporate operations other than through disclosures, the SEC possesses statutory authority to promulgate it. Any precedent creating a standard that allowed a judge, rather than the SEC, to determine the appropriate "mix" of financial and nonfinancial information is inconsistent with the "necessary or appropriate" language in the Exchange Act.

A second broad lesson of the human capital management disclosure case study is that, in at least some cases like human capital management, there are strong policy arguments that the SEC should mandate disclosures even when they touch on contested social issues.[19] There is an economic reason for the SEC to issue mandatory disclosures: left to their own choices, companies will choose to disclose less than the optimal amount of human capital management disclosures and will disclose information inconsistently, generating unnecessary information costs for investors. There is also an institutional reason: the SEC cannot abdicate its statutory mandate to protect investors and to ensure that securities markets are fair and efficient. Much information that is relevant to investors and that is already important to the mandatory disclosure system of the securities laws is not solely financial in nature. Human capital management is an important example. The practices of sophisticated investors support the view that human capital management disclosures provide investors with important information about business and financial performance, despite deep and obvious overlap with information related to unions, ages, diversity, and other matters of social and political importance.[20] Drawing the *policy* line of what types of disclosures ought to

17. 15 U.S.C. §§ 77g(a)(1), 78l(b)(1).

18. *See* Loper Bright Enters. v. Raimondo, 603 U.S. 369, 381 (2024).

19. For examples of articles making policy arguments in support of certain ESG-related proposals, see Colleen Honigsberg & Shivram Rajgopal, *Wage Wars: The Battle Over Human Capital Accounting*, 12 HARV. BUS. L. REV. 275 (2022) (financial accounting of human capital management); Virginia Harper Ho, *Modernizing ESG Disclosure*, 2022 U. ILL. L. REV. 277 (2022); Jill E. Fisch, *Making Sustainability Disclosure Sustainable*, 107 GEO. L.J. 923 (2019).

20. *See infra* notes 105-109 and 119-122 and accompanying text.

be mandated due to their nexus with social issues raises interesting and contested questions, but judgment calls on these matters are well within the remit of the SEC's role and authority.[21] Of course, critics will always dispute the boundaries of mandatory disclosures—otherwise, there would be no need for a system of *mandatory* disclosures.

Any good mandatory disclosure rule ought to at least plausibly pass a cost benefit test, at least as a policy matter. The public goods perspective advanced in this Article provides additional support for the passage of a mandatory human capital management disclosure rule. The benefits of mandatory disclosures could be numerous: more accurate securities prices;[22] reductions in transaction and information costs; positive externalities from information spillovers;[23] production of information about systematic risk that affects firms across the entire market;[24] and, perhaps, even marginally increased investments in our nation's workforce and human capital. But the costs of mandatory disclosures could also be significant: information and reporting costs; auditing costs; and diversion of managerial attention and legal resources; and contribution to frivolous, event-driven litigation, among others. A good rulemaking proposal would convene stakeholders and carefully weigh costs and benefits.

I. A PUBLIC GOOD PERSPECTIVE ON HUMAN CAPITAL MANAGEMENT

A. Human Capital Is a Corporate Asset

For most purposes in this Article, human capital can be defined as "the knowledge, skills and health that people invest in and accumulate throughout their lives, enabling them to realize their potential as productive members of

21. *See* Sec. and Exch. Comm'n, *Mission,* https://www.sec.gov/about/mission (last updated Aug. 9, 2023).

22. John C. Coffee, Jr., *The Future of Disclosure: ESG, Common Ownership, and Systematic Risk*, 2021 COLUM. BUS. L. REV. 602 (Arguing that the "future of disclosure" involves meeting the needs of large institutional owners about systematic risk, including about environmental and social risks of businesses); George S. Georgiev, *The Market-Essential Role of Corporate Climate Disclosure*, 56 U.C. DAVIS L. REV. 2105, 2110 (2023) [hereinafter *Market Essential Role*] (arguing that disclosure of climate information has a role in ensuring the accuracy of stock and bond prices on the capital markets); Georgeiv, *Human Capital Management Movement*, *supra* note 4 (highlighting the role of human capital management information in investor valuation).; *see also* Stavros Gadinis & Amelia Miazad, *Corporate Law and Social Risk*, 73 VAND. L. REV. 1401, 1414–15 (2020) (arguing that some companies are looking for protection from downside risks through their sustainability initiatives).

23. *See, e.g.*, Madison Condon, *Climate Services: The Business of Physical Risk*, 55 ARIZ. STATE L.J. 147 (2023).

24. Gordon, *supra* note 4; Coffee, *supra* note 22.

society."[25] This Section reviews arguments and evidence supporting the claim that human capital is a critical corporate asset with a direct connection to financial performance in many firms, especially firms providing services and technology.

Good human capital is an asset that contributes to the top and bottom line of a firm's operations. Scholars have claimed that human capital is a firm's "most crucial asset."[26] Corporate managers, too, claim that "our people are our greatest asset."[27] Human capital is critical for corporate production for obvious reasons: well-trained and highly qualified employees are a core pillar of firm-based production, especially in service economies.[28] Firms pay significant costs to acquire, retain, and deploy human capital. Human capital is overseen at the board level in most large firms. Likewise, virtually all large firms measure human capital indicators internally and actively manage human capital at the board and C-suite levels.[29] Firms make significant investments in human capital through their training and development programs. As such, human capital is an intangible asset.[30] Unlike a factory, it does not have a physical existence. Instead, it is stored in the employees of the firm. Hence, as an asset, human capital manifests itself throughout a firm's operations and contributes, usually mightily, to its financial results in ways that are very similar to other intangible assets like patents. In the same way, employee knowledge and expertise can be deployed and managed in ways that reduce costs and increase revenues.

Human capital is increasingly important to firms in the modern service economy.[31] A strong workforce can be a critical advantage in some specialized and high-tech industries where management of human capital

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25. World Bank Grp., *The Human Capital Project: Frequently Asked Questions*, https://www.worldbank.org/en/publication/human-capital/brief/the-human-capital-project-frequently-asked-questions (last updated Oct. 13, 2022).

26. Luigi Zingales, *In Search of New Foundations*, 55 J. FIN. 1623, 1624 (2000).

27. For an example, *See, e.g.*, Goldman Sachs, Our People & Leadership, https://www.goldmansachs.com/our-firm/our-people-and-leadership (last visited Nov. 3, 2024) ("Our people are our greatest asset – we say it often and with good reason. It is only with the determination and dedication of our people that we can serve our clients, generate long-term value for our shareholders, and contribute to our communities.").

28. Anat Alon-Beck, *Times They Are A-Changin': When Tech Employees Revolt!*, 80 MD. L. REV. 120, 136 (2020).

29. Ernst & Young, *How and Why Human Capital Disclosures Are Changing,* at 2, 4 (2019), https://assets.ey.com/content/dam./ey-sites/ey-com/en_us/topics/cbm/ey-how-and-why-human-capital-disclosures-are-evolving.pdf.

30. Due to unique features of workers, human capital does not meet the definition of an "asset" for financial reporting reasons. *See infra* note 58 and accompanying text.

31. Honigsberg & Rajgopal, *supra* note 19 at 285-87 (describing the rise of "human capital firms" and the importance of skilled labor in many industries).

issues is especially critical. In these industries, firms are locked in a "war for talent."[32]

A growing body of evidence shows that information related to human capital matters to *investors*, and matters a lot, for purposes of pricing securities.[33] For example, one study shows that firms with relatively high labor costs are associated with higher expected returns and are more sensitive to economic shocks.[34] Another important study shows that certain firms with satisfied employees are associated with better financial returns for investors.[35] Another study showed that including human capital in measures of aggregate wealth eliminates the unsatisfactory predictive power of the capital asset pricing model and eliminates the predictive power of size and book-to-market variables.[36] Talent poaching is also a primary concern for managers and investors because losing talent can be detrimental to a company's prospects.[37] Some recent research provides evidence suggesting that managers employ various strategies related to the risks and opportunities of poaching employees.[38] A sizable academic literature addresses the

32. Elizabeth G. Chambers, Mark Foulon, Helen Handfield-Jones, Steven M. Hankin & Edward G. Michaels III, The War for Talent, 3 MCKINSEY Q., no. 3, 1998 at 44, 46.

33. *See, e.g.*, Lynn Rees & David M. Stott, *The Value-Relevance of Stock-Based Employee Compensation Disclosures*, 17 J. APPLIED BUS. RSCH. 105, 114 (2001) (showing a relationship between employee stock option expenses and firm value); *Human Capital Management Movement*, *supra* note 4, at 703-04; AARON BERNSTEIN & LARRY BEEFERMAN, INV. RESP. RSCH. CTR. INST., THE MATERIALITY OF HUMAN CAPITAL TO CORPORATE FINANCIAL PERFORMANCE 2, 5 (2015), https://lwp.law.harvard.edu/files/lwp/files/final_human_capital_materiality_april_23_2015.pdf (metastudy concluding that "in aggregate the literature offers considerable empirical evidence that human capital policies can be material to corporate performance."); T. Russell Crook et al., *Does Human Capital Matter? A Meta-Analysis of the Relationship Between Human Capital and Firm Performance*, 96 J. APPLIED PSYCH. 443, 451–53 (2011) (metastudy concluding that human capital characteristics are positively correlated with firm value).

34. Andres Donangelo et al., *The Cross-Section of Labor Leverage and Equity Returns*, 132 J. FIN. ECON. 497, 517 (2019) (finding that firms with relatively high labor costs are associated with higher expected returns and are more sensitive to economic shocks).

35. Alex Edmans, *Does the Stock Market Fully Value Intangibles? Employee Satisfaction and Equity Prices*, 101 J. FIN. ECON. 621, 638 (2011) (showing that firms with high employee satisfaction ratings outperform industry benchmarks).

36. Ravi Jagganathan & Zhenyu Wang, *The Conditional CAPM and the Cross-Section of Expected Returns*, 51 J. FIN. 3 (1996). *See also* Daron Acemoglu, Francisco A. Gallego, and James A. Robinson, *Institutions, Human Capital, and Development*, ANN. REV. ECON. 875 (2014) (arguing that empirical models that treat institutions and human capital as exogenous are misspecified).

37. Qin Li, Ben Lourie, Alexander Nekrasov, & Terry Shevlin, *Employee Turnover and Firm Performance: Large-sample Archival Evidence*, 68 MGMT. SCI. 5667 (2022).

38. Diego Battiston, Miguel Espinosa, & Shuo Liu, *Talent Poaching and Job Rotation*, 71 MGMT. SCI. 1 (2024) (providing evidence that firms react to the risk that workers might be poached by competitors by rotating workers across multiple clients, and more frequently so for those workers more likely to be poached); Matthew J. Bloomfield et al., *Executive Incentives and Strategic Talent Acquisition: Evidence from Poaching* (working paper 2024) (Providing evidence that managers

significance of the legal and corporate finance aspects of human capital management, including equity-based compensation and non-compete agreements.[39]

Of course, individuals themselves make investments in their own human capital. Indeed, human capital is critical to individual well-being and human flourishing. Just look at the investment decisions people themselves make. Individuals make extraordinarily large investments in themselves and their human capital.[40] For many individuals, expenditures on school (or at least some part of those expenditures) are made for the purpose of enhancing career opportunities and job success. Many of us invest time in learning a new skill, trade, or programming language with the hope that it will provide us with meaningful employment, careers, and remuneration. Some people even make the costly investment of picking up their own life and their family members' lives to pursue work opportunities in a different location, even in a different country. Many people believe that work provides meaning and dignity. They are motivated to succeed and do well in their work, including, in part, by investing in themselves.

Despite all of these individual investments in human capital, investments by firms in human capital still promise returns. There is a lifecycle component. At some point, individuals must transition from school and join the labor force, and this transition must occur before they have exhausted profitable human capital investments in themselves. There is also a synergy component. Some learning and development is best and most efficiently done on the job.

In summary, human capital is an important corporate asset that has a clear connection with the profit and loss of a firm and with the firm's valuation by investors. The importance of human capital to financial results is well established, is textbook management theory, and is not tenuous or speculative.

B. Why Human Capital Is a Public Good and Why Markets Underinvest in

utilize poaching of hard-to-replace employees as an intentional strategy designed to reduce their competitors' profitability).

39. A subsection of this literature analyzes the importance of workers in startups and the unique issues that arise for these workers. *See, e.g.*, Anat Alon Beck, *Bargaining Inequality: Employee Golden Handcuffs and Asymmetric Information* 81 MD. L. REV. 1165, 1168, 1187–88 (2022); Yifat Aran, *Beyond Covenants Not to Compete: Equilibrium in High-Tech Startup Labor Markets*, 70 STAN. L. REV. 1235, 1264–68 (2018) (describing the use of stock options to encourage employee retention and development of human capital in startups); Yifat Aran, *Making Disclosure Work for Start-Up Employees*, 2019 COLUM. BUS. L. REV. 867, 917 (describing the difficulty of estimating the value of equity compensation in startups).

40. Theodore W. Schultz, *Investment in Human Capital*, 51 AM. ECON. REV. 1, 10-11 (1971).

Human Capital

The claim in this Section is that human capital is an impure public good. The significance of this claim, developed more in Section III.A, is that human capital is a "systematic" issue about which investors in the capital markets with diversified portfolios care.[41]

Human capital is an intangible asset. Generally, intangible assets are assets that have no physical existence. Examples of tangible assets include a manufacturing plant and inventory of goods. Examples of intangible assets include a proprietary manufacturing technology and brand name recognition.

As recent theory shows, intangible assets often possess the non-rivalrous and non-excludability characteristics of classic public goods.[42] A good is non-excludable if no individual can deny another individual the opportunity to consume a good. A good is non-rivalrous if one person's consumption of the good does not affect another's opportunity to consume it. A public good is said to be an "impure" public good if it satisfies the non-rivalry or non-excludable conditions only partially.

Like other intangible assets, human capital requires some storage mechanism. Training, expertise, knowledge, skills, and other aspects of human capital are stored in individuals. As I show, a consequence of this storage medium is that human capital impurely possesses both the non-rivalrous and non-exclusive characteristics of a public good.

Human capital is, to some degree, non-rivalrous. Workers can be deployed across different projects and different employers over time, bringing their human capital to different production processes. Moreover, human capital is not diminished by any individual employer's use at any given time. Rather, human capital is generally enlarged by more work experience and training. But human capital is partially rivalrous in a similar sense that a road or sidewalk is partially rivalrous. Human capital can only be deployed by one employer on a limited number of projects at one time.

Human capital is also non-excludable. Individuals are generally free to move between jobs at will. Even employee non-compete agreements cannot fully remove this non-excludability condition.[43] Non-compete agreements, when they are enforceable, provide only a partial solution. Because of the important public policy of not depriving anyone of a livelihood, non-compete agreements will not be enforced by courts unless they are "reasonable,"

41. *See* Gordon, *supra* note 4.

42. *See* Nicolas Crouzet, Janice C. Eberly, Andrea L. Eisfeldt & Dimitris Papanikoulaou, *The Economics of Intangible Capital*, 36 J. ECON. PERSPECTIVES 29, 29, 33–34 (2022).

43. *See* Aran, *Beyond Covenants Not to Compete*, *supra* note 39, at 1246–47 (explaining that noncompetes are only enforced when reasonable because of a broad economic "interest in employee mobility").

which generally requires them to be limited in time and geography.[44] Therefore, as a non-excludable and partially non-rivalrous good, human capital is an impure public good.

As is well known, public goods are prone to market failure problems: markets tend to underproduce public goods. Private production of public goods under pure market contracting is lower than the socially optimal amount.[45]

As an impure public good, human capital gives rise to the market failure problem that plagues the production of public goods: each employer would rather free ride on the training, development, and human capital management of other employers. Each individual employer personally bears all the costs of training, development, and management of human capital but captures only some of those benefits. Individual employers shift down their human capital management expenses below the optimal amount.

Some might deny that human capital investments create a public goods problem, arguing that markets efficiently address investments in human capital. It is possible that workers accept a lower wage in exchange for the training they expect to receive from employers. The argument is that employers with a better reputation for investing in their employees are more competitive in labor markets, allowing them to offer a lower wage. True, markets undoubtedly address some of the public goods problems implicated by human capital investments. Still, there are theoretical and observational reasons to believe that markets do not fully address these problems. There are various reasons why market mechanisms may fail. First, markets for labor are not perfectly competitive and without friction. Once an employee accepts a contract at a specified wage, they are locked into that relationship. Because it is costly and sometimes risky to switch employers and jobs, the outside options of workers may require accepting great costs. Thus, workers are subject to a hold-up problem that may make it difficult for them to enforce

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44. *Id.* at 1246 (presenting that noncompetes are enforced "to the extent that they are reasonable in scope and prescribe geographic parameters and limited duration").

45. An intuitive example of a classic public good is a road. Public roads create a common benefit. Everyone can ride on them to go to work, school, shops, or the like. Good roads lower the costs of commuting and minimize wear and tear on vehicles. However, roads are also costly to build. They require construction crews, trucks, cement, and other materials. The combination of a private cost and common benefit creates a collective action problem. People who build roads bear all the costs of building the road but they only capture a small amount of the benefit of everyone who drives on the road. Given this incentive problem, market contracting produces fewer roads than is socially optimal. Market underproduction of roads is intuitively obvious to us all. Consider your own decisions. It would be simply too expensive for you to, say, build your own private road from your neighborhood to your place of work. And neither would any of your neighbors want to build their own private roads. Nevertheless, roads are so valuable to us that it is hard to even imagine our modern economy without them.

the amount of training they expected to receive when they agreed to a given wage. This foreseeable hold-up problem makes it difficult to make an efficient bargain ex-ante about human capital investments. Second, training and investment in employees are only loosely determined by market mechanisms. Managers make decisions about training and investment in workers across months and years in processes that are only loosely tied to market mechanisms. Managers might not learn that they are investing a suboptimal amount in their workers until many months or years later when a large group of workers leave.

Then there is the observational data. The problems with corporate management of workers in the modern service economy appear to be increasing, and their deficiencies more apparent. Human rights commentators are raising concerns that poor treatment of workers is leading to systematic problems. For example, reportedly, some younger workers are engaged in "job hopping," feeling that corporate loyalty does not pay off.[46] Gallup's *State of the Global Workplace* report estimates that lack of employee engagement costs the global economy almost $9 trillion annually.[47] Recent survey data shows that job satisfaction is at an "alarming low."[48]

Given all the frictions and imperfections in the unique markets for labor markets and, specifically, in decisions to invest in workers, large institutional investors and other market participants may reasonably conclude that a public goods problem exists with respect to investments in human capital.

Underinvestment in the public good of human capital is a first-order problem for firms, their stockholders, and investors in other securities issued by the firm. Firms leave money on the table when they fail to train, develop, and retain talent. Investors make fewer investments at lower prices because of the adverse selection problems posed by uncertainty about human capital. Failure to manage human capital and to retain talent makes most lists of the causes of firm failures set forth by scholars and management experts.[49] Underinvestment in human capital is also a problem for workers and society.

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46. Ernestine Siu, *Corporate Loyalty Does Not Pay Off, HR Expert Says, as Job Hopping Gains Currency Among Young People*, CNBC (Aug. 21, 2024, 10:05 PM), https://www.cnbc.com/2024/08/22/gen-zers-and-millennials-are-increasingly-rejecting-corporate-loyalty.html (describing a worker who "is part of a generation that appears to be challenging the ideas of corporate loyalty.").

47. GALLUP, STATE OF THE GLOBAL WORKPLACE, 2-3 (2024), https://www.gallup.com/workplace/349484/state-of-the-global-workplace.aspx.

48. Dexter Tilo, 'Alarming Low': Only 22% of Employees Satisfied with Job, HUM. RES. DIR. (Jan. 15, 2024), https://www.hcamag.com/us/specialization/employee-engagement/alarming-low-only-22-of-employees-satisfied-with-jobs/472932.

49. *See, e.g.*, Albert V. Bruno et al., *Why Firms Fail*, Mar.-Apr. BUS. HORIZONS 50, 57 (1987) (describing how failures to manage human capital contributed to firm failures); Bernard Marr, *Top*

C. Legal Solutions? The Analogy of Intellectual Property

Legal solutions might be employed to mitigate the public good problem posed by human capital. The role of legal interventions can be seen by analogy to intellectual property law. This Section also discusses how patent law provides a partial legal solution to the market failure problem for intellectual property. However, the intellectual property analogy also highlights how traditional legal solutions are not available in the case of human capital because of the unique feature of labor: employees are generally free to switch jobs as a matter of public policy and employers can impose only limited restrictions on their ability to do so.

Production of the public good by the government is one mechanism to address a public good market failure problem. Government provision of national defense is a primary example.[50] The federal interstate highway system is another. More recently, Congress has deployed similar reasoning in expanding the Internet to rural low density areas and doing so at public cost.[51] The collective action challenges created by public goods are cited as a textbook justification for government intervention.

Another mechanism to address market failure problems is private production of "club goods" through the efforts of entrepreneurs. While private markets can sometimes provide "club goods," in practice, such collective action by market forces alone is relatively rare because it is costly to overcome incentive frictions and transaction costs.[52]

Consider an example of how intangible assets can have the characteristics of public goods that are prone to market failures: research, development, and production of intellectual property. I select intellectual property as a baseline example since there is considerable research on and consensus about the basic contours of the public goods problem posed by

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Ten Reasons Why Businesses Will Fail over the Next Ten Years, FORBES (Aug. 29, 2022, 01:20 AM), https://www.forbes.com/sites/bernardmarr/2022/08/29/the-top-10-reasons-why-businesses-will-fail-over-the-next-10-years/ (stating that the failure to attract and keep talent as a reason why businesses fail).

50. STAN. ENCYC. PHIL., PUBLIC GOODS § 1.1 Non-Rivalry and Non-Excludability (2021), https://plato.stanford.edu/entries/public-goods/ ("National defen[s]e is a paradigmatic example of a public good").

51. *See* 47 U.S.C.A § 1701 (finding the "'digital divide' in the United States" to be a "barrier to . . . equitable distribution of essential public services").

52. Continue the example of provision of a public road. *See* discussion *supra* note 45. Collective action imposes coordination costs—people in my neighborhood drive to different locations and have different preferences about where to build roads. There are incentive problems created by collective action challenges. Each individual would rather free ride on the costly efforts of others rather than contribute at a personal cost. Finally, there are costs in designing and implementing a mechanism that solves this collective action problem—for example, manning the toll booth and enforcing payments.

intellectual property.[53] According to the academic literature on intellectual property, markets fail to produce the optimal amount of intellectual property because of a classic public goods problem.[54]

As an intangible asset without tangible existence, intellectual property must be "stored" in some sense. The storage technology influences the degree of non-excludability and non-rivalry. Knowledge and ideas—the stuff of intellectual property—are stored in people's heads, on paper, or in software. Pure ideas are generally non-excludable and non-rivalrous, making them classic public goods. Consider the idea of using the wheel to transport heavy items. The person who invented the wheel had limited ability to exclude others from adopting that world-changing technological innovation. Moreover, that person's use of the wheel did not diminish the ability of other persons to use their own wheels. Others undoubtedly created their own wheelbarrow after observing the inventor using one. The ability of others to freeride on technological innovations lowers incentives for producing innovation.[55] Because others will copy innovation, incentives to sink the fixed cost investment that it takes to advance technological innovation are muted.

Because intellectual property is a public good that gives rise to market failure in the absence of a legal or other solution, companies would generally not invest in the optimal amount of research and development under market contracting.

However, a legal solution to the market failure problem associated with intellectual property exists, at least an imperfect one. The patent system directly addresses the market failure problem. Patents permit innovators to "propertize" their innovations, giving them a legal right to exclude others from using protected ideas.[56] With a legal system of patents in place, innovators and corporations have incentives to engage in research and development that are closer to the social optimum amount compared to market outcomes. Indeed, patented property and other intellectual property form a key asset on the balance sheets of many corporations, especially in the modern technology and service economy.

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53. *See, e.g.*, Richard A. Posner, *Intellectual Property: The Law and Economics Approach*, 19 J. ECON. PERSPECTIVES 57, 64 (2005) (stating that "intellectual property is a public good" and analogizing problems in intellectual property to other public goods problems "in the physical domain"); Kenneth W. Dam, *The Economic Underpinnings of Patent Law*, 23 J. LEGAL STUD. 247, 250 (1994) (describing patents as resulting "in the patentee enjoying economic rent" through the power to exclude others from manufacture, use, and sale").

54. Posner, *supra* note 53, at 64.

55. *Id*. at 58.

56. Dam, *supra* note 53, at 247; Posner, *supra* note 53, at 57.

While patent law addresses public goods problems for intellectual property, no comparable legal mechanism exists for human capital public goods problems, and there cannot be. As a matter of rights and public policy, individuals have the ability to change jobs at their will, subject only to "reasonable" limitations in enforceable noncompete agreements.[57]

II. WHY VOLUNTARY HUMAN CAPITAL MANAGEMENT DISCLOSURES ARE INADEQUATE: THEORY AND EVIDENCE

What is the state of current public information about human capital management? It is not adequate, as this Section shows. Section II.A discusses existing reporting frameworks and proposals to address their deficiencies. Section II.B empirically documents the inconsistency, incomparability, and incompleteness of voluntary human capital management disclosures in almost 50 public companies.

A. Existing Accounting and Reporting Frameworks Are Inadequate

1. Current Practices

Current financial reporting practices make it difficult to understand and interpret the role of human capital management in the financial results of a company. According to Professors Honigsberg and Rajgopal, "human capital is likely the biggest asset missing from firms' balance sheets" in today's economy.[58] Largely because of the lack of control over workers and for some other nuanced reasons, workers do not meet the definition of an "asset" under GAAP principles. Physical assets like factories, over which a firm has complete control, show up as assets. But human capital does not. At the heart of organizational law is the lock-in of capital that can occur through entity separateness.[59] But firms cannot lock in human capital the way they lock in paid-in organizational capital.

Moreover, everything related to human capital in the profit and loss statement shows up as an expense.[60] No category exists to link the contribution of human capital to revenues.

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57. Aran, *supra* note 43, at 1246-47 (pointing out the "broader economy's interest in employment mobility").

58. Honigsberg & Rajgopal, *supra* note 19.

59. *See* Henry Hansmann & Reinier Kraakman, *Organizational Law as Asset Partitioning*, 44 EUR. ECON. REV. 807 (2000); Margaret M. Blair, *Locking in Capital: What Corporate Law Achieved for Business Organizers in the Nineteenth Century*, 51 UCLA L. REV. 387 (2003).

60. Ethan Rouen, *The Problem with Accounting for Employees as Costs Instead of Assets*, HARV. BUS. REV. (Oct. 17, 2019), https://hbr.org/2019/10/the-problem-with-accounting-for-employees-as-costs-instead-of-assets.

Moreover, even the expense reporting that is required about human capital does little to clarify the role of human capital management in the financial results. First, GAAP does not require disaggregating the expense categories.[61] This means that expenditures related to employees are aggregated and not separately reported, such as, training, wages, retirement, or non-retirement benefits, but they are rather broken up into different expense buckets like costs of sales or research and development, often without details about the role of human capital management in each bucket. Second, human capital management expenses generally show up as *current* expenses. This is a misleading categorization to the extent that expenses on human capital management are *investments* that are expected to produce benefits over time. When an investment in a manufacturing plant is made, those expenses are recorded as an asset and thereafter depreciated and hit the profit and loss statement over a period of time. Similarly, research costs are recorded as an asset and then amortized over the expected life of the product or service they produce. Human capital management expenses, in contrast, are reported to be profit and loss in the current period.[62] This distorts incentives, making it relatively more costly to make investments in human capital that will pay off over time.[63]

In 2020, the SEC amended its disclosure rules applying to Exchange Act reporting companies.[64] Subject to a materiality qualifier, the rules require reporting companies to provide:

> "A description of the registrant's human capital resources, including the number of persons employed by the registrant, and any human capital measures or objectives that the registrant focuses on in managing the business (such as, depending on the nature of the registrant's business and

61. Some change is coming on this front. In July 2023, the Financial Accounting Standards Board issued a proposal that would mandate that companies disaggregate the reporting of major operating costs and would require companies to show employee compensation costs including in the profit and loss statement. Fin. Acct. Standards Bd., *Proposed Accounting Standards Update*, at 27, 33-35, 37 (July 31, 2023), https://www.fasb.org/standards/accounting-standard-updates.

62. The Working Group on Human Capital Accounting Disclosure, *Petition for Rulemaking* (June 7, 2022), at 2, https://www.sec.gov/files/rules/petitions/2022/petn4-787.pdf.

63. *See* Letter from Mark R. Warner, U.S. Senator, to Jay Clayton, Chairman, Sec. & Exch. Comm'n, 3 (July 19, 2018), https://www.scribd.com/document/384237385/2018-07-19-Letter-to-the-SEC-2018-Regulation-S-K.

64. *Federal Register*, *Modernization of Regulation S-K*, Final Rule [Effective Date Nov. 9, 2020], Release No.33-10825 (Aug. 26, 2020); *Federal* Register, *Modernization of Regulation S-K*, Proposed Rule, Release No. 33-10668, at 5, 8 (Aug. 8, 2019); *Federal Register*, *Business and Financial Disclosure Required by Regulation S-K*, Concept Release, Release No. 33-10064, at 6 (Apr. 13, 2016).

> workforce, measures or objectives that address the development, attraction and retention of personnel)."[65]

The materiality qualifier specifies that the disclosure is necessary only if the required information is material to an understanding of the registrant's business taken as a whole, or to a specified business segment.[66]

The SEC chose not to define the term "human capital" because it took the view that "this term may evolve over time and may be defined by different companies in ways that are industry specific."[67]

The primary criticism levied at the SEC's human capital management disclosure rule is that it will not result in comparable disclosures across registrants.[68] Critics say that the lack of comparability results from the SEC adopting a principles-based approach rather than a more prescriptive approach.[69] First, the rule does not define "human capital," giving reporting companies discretion about what falls under the disclosure mandate. Second, the rule requires disclosure of human capital management resources with an important qualifier: those "that the registrant focuses on in managing the business." This subjective frame grants significant discretion to issuers in making judgments about what information to disclose. This discretion makes it more likely that managers will cherry pick only the human capital management information that is good while remaining silent on the bad information. Third, the materiality qualifier introduces additional comparability concerns. Each company has to make its own materiality determinations, and it is unlikely that companies will have similar materiality thresholds or even that materiality determinations will be made in a comparable manner across registrants.

Following the rule change, voluntary disclosure about human capital management increased, at least to some extent, but remained inconsistent and lacked comparability.[70] These issues are discussed further in the discussion of the empirical analysis of human capital management disclosures in Section II.B below.

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65. *Federal Register*, *Modernization of Regulation S-K*, Final Rule [Effective Date Nov. 9, 2020], Release No.33-10825, Item 101(c)(2) (Aug. 26, 2020).

66. *Id*.

67. *Federal Register*, *Modernization of Regulation S-K*, Final Rule [Effective Date Nov. 9, 2020], Release No.33-10825 (Aug. 26, 2020).

68. Allison H. Lee & Caroline A. Crenshaw, *Joint Statement on Amendments to Regulation S-K: Management's Discussion and Analysis, Selected Financial Data, and Supplementary Financial Information,* SEC. & EXCH. COMM'N (Nov. 19, 2020), *https://www.sec.gov/news/public-statement/lee-crenshaw-statement-amendments-regulation-s-k*.

69. *Id.*

70. Maia Gez, Era Anagnosti, and Taylor Pullins, *ESG Disclosure Trends in SEC Filings*, HARV. L. SCH. F. ON CORP. GOVERNANCE (July 16, 2022), https://corpgov.law.harvard.edu/2022/07/16/esg-disclosure-trends-in-sec-filings/.

As of spring 2023, the staff of the SEC has indicated that it is considering proposed rule amendments that would "enhance registrant disclosures regarding human capital management."[71] However, no action has been taken to date.

2. Proposed Reporting Standards

Various standard-setting organizations and investor groups have proposed frameworks for improving and standardizing human capital management disclosures. This Section reviews a few of the leading proposals.

A group of academics, market participants, and former SEC officials under the label of "The Working Group on Human Capital Accounting Disclosure" presented a prominent proposal, emerging from a paper by Professors Honigsberg and Rajgopal.[72] The proposal recommended requiring reporting companies to include narrative disclosures in the management discussion and analysis (MD&A) of the financial results section of their Form 10-K on what portion of labor costs management views as an investment in labor.[73] The proposal also calls for disclosures in a standardized grid of certain prescribed information, including disclosures about mean tenure, employee turnover, and compensation costs broken out across categories like salary, bonus, pension and deferred compensation, health care, training, stock/option awards, and others.[74] The proposal also advocated for disaggregating human capital expenses on the income statement, a proposal that may be partially addressed by a recent Financial Accounting Standards Board proposal related to standards under Generally Accepted Accounting Principles.[75]

The SEC's Investor Advisory Committee released a proposal in September 2023 that was broadly consistent with the Working Group in Human Capital Accounting Disclosure proposal.[76] The Investor Advisory Committee proposal recommends prescriptive disclosures on enumerated topics, including the total number of people employed; the percentage of full-

71. Barry Summer, *Human Capital Management Disclosure*, SEC. & EXCH. COMM'N (Spring 2023), https://www.reginfo.gov/public/do/eAgendaViewRule?pubId=202304&RIN=3235-AM88; *see also* Lee & Crenshaw, *supra* note 68.

72. *See* The Working Group on Human Capital Accounting Disclosure, *supra* note 62, at 1-2.

73. *Id.* at 5.

74. *Id.* at 5-6.

75. *Id.* at 5, 7-8.

76. Investor Advisory Committee, *Recommendation of the SEC Advisory Committee's Investor-as-Owner Subcommittee Regarding Human Capital Management Disclosure*, SEC. & EXCH. COMM'N, at 3 (Sept. 21, 2023), https://www.sec.gov/files/spotlight/iac/20230921-recommendation-regarding-hcm.pdf.

time, part-time, and contingent workers; turnover metrics; total workforce costs, broken down into components; and worker demographic data.[77] Moreover, the proposal also called for narrative disclosure in the MD&A section of how the reporting company's labor practices, compensation incentives, and staffing fit within the broader firm strategy. The proposal contemplates that such a discussion would address "what portion of labor costs management views as an investment and why" and how labor is allocated to promote firm growth, including research and development.

B. Empirical Analysis: Voluntary Disclosures Are Inadequate

Given that human capital information is important to investors, perhaps firms are already voluntarily disclosing it. As a descriptive matter, what types of human capital management disclosures are firms voluntarily making? Additionally, what drives voluntary disclosure of human capital issues? This Section presents descriptive statistics and qualitative examples of human capital management disclosures.

Despite the first-order contribution of human capital management to financial performance, the inductive analysis does not support the view that markets are producing adequate information about investments in human capital. The primary empirical result in Section II.B.1 is that human capital management disclosures across public companies are fragmented, inconsistent, and incomparable. A secondary result is that the disclosures most promoted by leading proposals—including detailed financial reporting on human capital expense categorization and a narrative description of human capital investments in the management's discussion and analysis section—are reported by virtually no companies. The primary empirical result in Section II.B.2 is that the voluntary disclosure of human capital management that already exists does not appear to be driven primarily by values or by the fixed costs of disclosures.

1. Descriptive Statistics and Narrative Examples of Human Capital Management Disclosures

I collected data on voluntary human capital management disclosures from three groups of companies. First, a random sample of fifteen firms in the S&P 100, some of the country's largest and most well-known firms (the "large-capitalization" group).[78] Second, all publicly listed public benefit

77. *Id.* at 2-3.

78. Abbott Laboratories, AT&T, Inc., Broadcom, Inc., Coca-Cola, CVS Health Corp, Duke Energy Corp, GE, General Dynamics Corp, International Business Machines Co, Lowes Companies, Inc., Medtronic PLC, Microsoft Corp, Morgan Stanley, Netflix, Inc., & Tesla, Inc.

corporations (the "public benefit corporation" group), also a total of fifteen firms.[79] Third, a matched sample group of small-capitalization comparison firms that are not public benefit corporations but that are similar in size, net income, industry, and other observable measures as the public benefit corporation sample (the "small-capitalization" group).[80]

Because I collected disclosures from each company's most recent annual report (Form 10-K filed with the SEC) my efforts likely understate actual human capital disclosures made by the companies studied because some companies omit their reporting of human capital matters from their SEC filings but include such disclosures in stand-alone sustainability reports. I chose to collect from the 10-K instead of sustainability reports for three reasons. First, annual reports are required by law and have prescribed requirements, making them more comparable to voluntary sustainability reports. They are a better measuring stick to compare disclosures across companies. Second, disclosures in annual reports can be seen as more reliable as they are subjected to regular review and evaluation by SEC staff for accuracy and consistency. Misstatements and omissions in disclosures in annual reports are more vulnerable to litigation under the antifraud rules of the securities laws, especially if the annual report is incorporated by reference into any offerings under a shelf registration.[81] Finally, information in SEC reports is probably used more by investors since it is a relatively lower cost to obtain and analyze the information. Investors have standardized ways of

79. The sample of publicly listed public benefit corporations is taken at the end of 2023 and includes: Allbirds, Inc., Amalgamated Financial, BRC Inc., Broadway Financial Corp, Coursera, Grove Collaborative Holdings, Inc., Laureate Education, Lemonade, Inc., Planet Labs PBC, Sezzle Inc., United Therapeutics Corp, Veeva Systems, Inc., Vita Coco Company, Vital Farms, Inc., Warby Parker, & Zevia PBC.

80. To construct the matched sample, I downloaded all observations in the Compustat database as of the end of 2023. I eliminated observations that had missing data on the covariates used for matching. I used propensity score matching to create a comparison group for the group of publicly listed public benefit corporations. I used a 1:1 nearest neighbor propensity score matching without replacement with a propensity score estimated using a logistic regression of public benefit corporation status on total assets, ebidta, net income, domestic or foreign status, naics code and sic code. The matched sample includes: Adeia Inc., Banner, Bigbear.AI Holdings, Inc., BridgeBio Pharma, Inc., Bluerock Homes Trust, Inc., Capital Properties, Inc., Crowdstrike Holdings, Inc., Genpact Limited, Healthcare Triangle, Inc., Hesai Group, Mercury General Corp, National Research Corp, & Opko Health, Inc.

81. Liability is less likely after the U.S. Supreme Court's decision in *Macquarie Infrastructure Partners v. Moab Partners, L.P.*, 601 U.S. 257, 260 (2024) (holding that pure omissions are not actionable under Rule 10b-5(b)). First, the SEC could still pursue enforcement. Regarding private litigation, the decision does not foreclose liability for omissions under the securities laws. Omissions may still be actionable under Rule 10b-5(a) or (c). Moreover, there may be administrative or legislative responses to Macquarie to come, such as a requirement that an executive from the issuer certifies that the disclosures contain all information required by applicable rules.

downloading and comparing data from the SEC's Edgar system, but it is more costly to trawl for bespoke disclosures in sustainability reports that are often posted on each individual company's website.

In collecting the data, I created buckets of disclosure categories, following the most prominent human capital management proposals, including those described in Section II.A.2. I coded a variable as a "yes" if the company made some type of disclosure in that category and a "no" if they did not. Of course, this is a crude classification strategy. It lumps together fulsome disclosures with sparse disclosures that contain relatively little information. The idea is just to get a baseline sense of whether companies are disclosing *anything* on these topics. By giving a few examples, I also highlight the range in diversity of disclosures in each category.

Table I presents descriptive statistics.

	PBC	Match	S&P100
Workforce Data			
Specifies Number of Employees	100%	93%	100%
Percentage Full-Time Employees	56%	64%	20%
Percentage Part-Time Employees	6%	21%	7%
Percentage of Contractors	13%	14%	0%
Turnover	6%	14%	13%
HCM Investments			
Discussion in MD&A	0%	0%	0%
Training	63%	57%	93%
Talent Acquisition Strategy	44%	29%	33%
Workforce Costs			
Categorizes Labor Costs	0%	0%	0%
Compensation Scheme	63%	57%	80%
Engagement			
Engages In Employee Surveys	44%	21%	67%
Employee Engagement	50%	36%	53%
Health, Safety, Human Rights			
Employee Health/Safety	50%	36%	80%
Human Rights	13%	0%	13%
Demographics			
Gender Breakdown	44%	14%	47%
Race/Ethnicity Breakdown	44%	7%	40%
Age Breakdown	0%	7%	0%
DEI			
DEI	94%	57%	80%
Pay Equity	19%	14%	60%
Governance			
Board Authority over HCM	38%	14%	33%
10-K Separate Section	88%	93%	93%
Culture	63%	36%	60%

Table I: Disclosure Rates of Various Human Capital Management Categories by Firm Group. This table discloses the percentage of firms across three different groups of firms that make some type of disclosure in various human capital management categories. *Turnover* is defined as quantitative data about turnover rates, including mean tenure or periodic departure data. *HCM Investment Discussion in MD&A* is defined as qualitative data discussion in the management's discussion and analysis about what percentage of labor costs are viewed as an investment. *Training* is defined as qualitative statements about mentoring, learning programs, learning management systems, and training programs. *Discusses Talent Acquisition Strategy* is defined as qualitative disclosures about talent acquisition and retention programs or systems. *Categorizes Labor Costs* is defined as a quantitative breakout of labor expenses by category, including, for example, bonuses, pension, stock awards, health care, etc. *Workforce Compensation Scheme* is defined as narrative disclosure rather than quantitative disclosure about workforce compensation practices. *Engages In Employee Surveys* is defined as qualitative disclosures about engaging employees with surveys. *Employee Engagement* is defined as qualitative statements about employee engagement. *Employee Health/Safety* is defined as qualitative disclosures about efforts to manage employee health and safety. *Human Rights* is defined as qualitative disclosures about efforts to respect the human rights of employees or other firm patrons, including workers in the supply chain. *DEI* is defined as qualitative discussion about diversity, equity, and inclusion. *Pay Equity* is defined as qualitative or quantitative statements about pay equity, e.g., gender wage gaps. *Board Authority Over HCM* is defined as a disclosure that expressly states that the board has authority over and/or manages human capital management issues. *10-K Separate Section* designates whether the annual report breaks out human capital management disclosures in a separate section. *Culture* is defined as qualitative statements about the culture of workers or the firm.

The descriptive statistics produce two important results. First, there are almost no disclosures of information in the categories deemed most important by prominent disclosure proposals.[82] Second, the types of

82. These results are consistent with other analyses that have found that human capital management disclosures remained inconsistent and incomparable years after the 2020 human capital management disclosure rule was promulgated. *See Form 10-K Human Capital Disclosures Continue to Evolve,* GIBSON DUNN (Nov. 21, 2023), https://www.gibsondunn.com/wp-content/uploads/2023/11/form-10-k-human-capital-disclosures-continue-to-evolve.pdf.

voluntary disclosure that actually are made are inconsistent, incomparable, and fragmented.

Only one of the categories contains disclosures by nearly all firms in each of the three samples: disclosure about the total number of employees. This is not surprising since this is one of the only prescriptive disclosures required under the SEC's 2020 human capital management disclosure rule.[83] The only other market practice adopted by nearly 90% of reporters in all categories was to break human capital management disclosures out into a separate section of their annual reports.

Other than these two similarities, the analysis does not reveal any other standard market practices for voluntary human capital management disclosures.

There is, however, some consistency in disclosure practices: *omissions* of certain human capital management disclosures. The omitted information contains some of the information that is most critical according to leading disclosure proposals.

First, no company in the dataset provided a qualitative, narrative discussion in the management's discussion and analysis about what percentage of labor costs are viewed as an investment. This particular disclosure is perhaps the one that is most recommended by standard setting organizations and investor groups.[84] Second, no company provided detailed, categorized information about labor costs.[85] The "Categorizes labor costs" category was set to "yes" if the annual report included a quantitative breakout including bonus, pension, stock awards, health care, and similar disclosure, and a "no" otherwise. Only a handful of companies in the public benefit corporation sample and the small-capitalization sample made these detailed disclosures. None of the large-capitalization companies in the S&P100 did so. Detailed disclosures about expense categorizations related to human capital management are also among the most recommended by experts.[86]

2. What Is Driving Voluntary Human Capital Management Disclosures? Testing Two Hypotheses

What else can be learned from the data? The design behind collecting data for three groups of firms was to enable comparisons across groups by

83. 17 C.F.R. § 229.101(c)(2)(ii) (2020) (Provide, subject to a materiality qualifier, "[a] description of the registrant's human capital resources, *including the number of persons employed by the registrant*.") (emphasis added).

84. *See supra* Section II.A.2.

85. GAAP is working on creating standards for disaggregating such expenses, so a solution to this issue might be forthcoming. *See* Fin. Acct. Standards Bd., *supra* note 61.

86. *See supra* Section II.A.2.

comparing group means. This Section tests two hypotheses. First, I ask whether the evidence is consistent with a theory that human capital management disclosures are driven by ideology or values. Second, I ask whether the evidence is consistent with a theory that human capital management disclosures are driven by internal reporting capabilities or fixed cost considerations.

My test for whether disclosures are motivated by ideology or values is to compare rates of disclosures by publicly listed public benefit corporations against the matched sample. The assumption is that public benefit corporations are, other things equal, relatively more likely to have managers and owners that value human capital or labor, and they might want to signal these values to like-minded investors. This assumption may be questioned because none of the public benefit corporations in the sample specifically list the promotion of human capital or labor as the stated public benefit in their charter. Nevertheless, the test may still be informative if the types of values that motivate investors to own and managers to work for a public benefit corporation are correlated with support for the promotion of human capital.[87]

My test for whether internal reporting capabilities or fixed cost considerations drive voluntary disclosures is to compare the S&P 100 firms against the small capitalization firms. Comparing these two groups provides a crude test of whether fixed costs might matter to human capital management disclosures. The assumption is that large firms are more likely to sink the fixed costs necessary to track and report human capital management data and are more likely to incur the marginal costs of periodic disclosures. Large firms may also be more likely to sink the fixed and marginal costs of hiring lawyers, drafting the disclosures, and the opportunity costs associated with more robust disclosures.

Table II reports differences in rates of disclosure across the public benefit corporation cohort, the matched cohort, and the S&P100 cohort. It shows the raw percentage-point difference in disclosure rates. So, in my sample, 56% of public benefit corporation firms disclosed their percentage of full-time employees compared to 20% of corporations in the S&P100 sample, a difference of 36 percentage points.

87. Ryan Bubb & Emilano M. Catan, *The Party Structure of Mutual Funds*, 35 REV. FINANCIAL STUD.2,839, 2,840 (2021) (showing that the voting behavior of large institutional investors predictably belong to "parties" that follow distinctive philosophies of corporate governance and shareholders' roles).

	PBC (relative to Match)	PBC (relative to S&P100)	Match (relative to S&P100)
Workforce Data			
Specifies Number of Employees	+7	0	-7
Percentage Full-Time Employees	-8	**+36**	**+44**
Percentage Part-Time Employees	-15	+0	+14
Percentage of Contractors	-2	+13	+14
Turnover	-8	-7	+1
HCM Investments			
Discussion in MD&A	0	0	0
Training	+5	**-31**	**-36**
Talent Acquisition Strategy	+15	+10	-4
Workforce Costs			
Categorizes Labor Costs	0	-7	-13
Compensation Scheme	+5	-18	**-23**
Engagement			
Engages In Employee Surveys	**+22**	**-23**	**-46**
Employee Engagement	+14	-3	-17
Health, Safety, Human Rights			
Employee Health/Safety	+14	**-30**	**-44**
Human Rights	+13	0	-13
Demographics			
Gender Breakdown	**+29**	-3	**-33**
Race/Ethnicity Breakdown	**+37**	+4	**-33**
Age Breakdown	-7	0	+7
DEI			
DEI	**+37**	+14	**-23**
Pay Equity	+4	**-41**	**-46**
Governance			
Board Authority over HCM	**+23**	+4	-19
10-K Separate Section	-5	-6	0
Culture	**+27**	+3	**-24**

Table II: This Table presents differences in disclosure rates for various categories of disclosures across three cohorts of firms: the public benefit corporation cohort, a matched sample, and a sample of firms in the S&P100. See Table 1 for a description of disclosure categories. Figures in bold

represent differences in group means that exceed a cutoff threshold of 20 percentage points. For example, the mean number of companies in the PBC sample that disclose information about the number of full-time employees is 36 percentage points more than the rate of firms in the S&P100 sample that disclose for this category.

Overall, the rates of disclosure look relatively similar across the groups for the majority of categories. There is no robust systematic pattern on the face of the table. In the following analysis, I highlight differences in group means of twenty percentage points or more. This is not a scientific cutoff but rather a crude, qualitative significance cutoff. With the primary data provided in Table 1, readers could calculate any cutoff they think is more appropriate.

The interpretation of the first test provides some evidence to support the theory that certain voluntary disclosures are driven by ideology or values. However, any such support is relatively modest overall. In general, the rates of human capital management disclosures do not differ in a systematic way across publicly listed public benefit corporations and matched corporations.

Public benefit corporations make more disclosures related to the governance of human capital management compared to matched firms. Public benefit corporations make more disclosures specifying the board of directors' oversight of human capital management issues and employee engagement, particularly with respect to disclosures about engaging in surveys of employees. Additionally, public benefit corporations make relatively more disclosures about demographics and DEI. Almost half of public benefit corporations made demographic disclosures about each of gender and race, compared to 14% and 7%, respectively, for the matched sample. All but one of the public benefit corporations made disclosures about DEI, compared to 57% of the matched companies.

There is also some modest evidence supporting the claim that voluntary disclosures are driven by costs, but again this evidence is modest. Overall, the S&P100 firms have the highest rates of disclosure of human capital management categories compared to both the public benefit corporation firms and the small capitalization firms.

Compared to small capitalization firms, large capitalization firms are more likely to make disclosures about employee training, workforce compensation schemes, employee surveys, employee health and safety, gender demographics, race/ethnicity demographics, pay equity, employee culture, and board authority over human capital management issues. The only category that large capitalization firms disclose at considerably lower

rates than small capitalization companies is the percentage of full-time workers.

III. WHY MANDATORY HUMAN CAPITAL DISCLOSURES COULD IMPROVE INVESTMENT AND VOTING DECISIONS

This Part describes a channel through which human capital disclosures might advance the goals of the securities laws while also helping to correct the public good and market failure problems implicated by human capital management: mandatory disclosures. The importance of many ESG issues to the traditional functions of the securities laws is hotly contested. But the significance of human capital management disclosures should not be contested. Whatever their social implications may be, human capital management has a direct nexus with the core investor functions of evaluating investment decisions, voting in director elections, and engaging with directors on corporate governance issues for the purpose of enhancing firm value.

A. What Is the Optimal Level of Human Capital Management Disclosure? The Universal Owner Analytical Benchmark

What is the optimal level of human capital management disclosure? While a good rulemaking process would consider many perspectives on this issue, one of the most important ones to consider is that of the diversified investor with a large portfolio of companies.

This Section adopts the perspective of large institutional owners that invest in a diversified portfolio of securities—"universal owners"—as an analytical benchmark. There are four primary reasons for adopting this perspective as a benchmark. The practical reason is that universal owners own and control enormous amounts of securities, more than any other identifiable group of investors.[88] The policy reason to adopt the perspective of a universal owner is that this perspective is the closest perspective to the socially optimal perspective—a widely adopted normative criterion in economic analysis—that also fits squarely within the objectives and purposes of the securities regulation: providing information that informs investment and voting decisions.[89] A third reason is doctrinal. In many cases, the SEC

88. Coffee, *supra* note 22, at 606 (describing an "extraordinary concentration in stock ownership, with the result that as few as five to ten institutions today may be in a position to exercise de facto control over even large public corporations").

89. There are arguments in corporate law why directors should not be required to make decisions based on a portfolio standard. *See* McRitchie v. Zuckerberg, 315 A.3d 518, 529-30 (Del. Ch. 2024). But these reasons do not necessarily apply to the federal regulator tasked with producing

must determine whether information is material to investors, and the U.S. Supreme Court has said that the "materiality" test is conducted from the perspective of a "reasonable" investor.[90] Moreover, modern portfolio theory suggests that reasonable investors should diversify.[91] Thus, the diversified investor perspective must, at a minimum, constitute a significant perspective in inquiries regarding the materiality of information. A final, less persuasive, reason to adopt this position is that there is generally no accepted alternative perspective that provides a tractable means of analysis.[92]

There is now a well-established theory explaining why universal owners prefer to efficiently manage inter-firm negative externalities at the *portfolio* level rather than at the firm level.[93] For example, investors that own both a chemical company and a fishing company would prefer that the chemical company refrain from polluting waterways when the costs of safe waste management are less than the costs to a fishing company from pollution. Because the investor owns both companies, the investor personally internalizes the costs from pollution to the fishing company and prefers that inter-firm externalities are efficiently managed *at the portfolio level*.

In this Article, I focus on a different aspect of the externality problems faced by universal owners. With the strong focus on negative externalities in corporate governance discourse, particularly with respect to climate issues, it is less discussed that universal owners prefer that their portfolio firms efficiently produce inter-firm *public goods*.[94] By producing a common

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disclosure requirements aimed at promoting informed decision-making by investors and at ensuring fair, orderly, and efficient securities markets.

90. TSC Industries, Inc. v. Northway, Inc., 426 U.S. 438, 448-49 (1976).

91. *See generally,* Burton G. Malkiel, A Random Walk Down Wall Street (2015) (discussing how diversification enables investors to lower their expected risk for any given amount of expected financial returns).

92. While some critics of the climate disclosure rule have asserted that the SEC should more carefully consider the perspective of retail investors in that rule, some commentators have persuasively argued that retail investors primarily obtain protection by freeriding on the price efficiency created by more sophisticated investors, questioning whether many retail investors even read disclosures at all. Holger Spamann, *Indirect Investor Protection: The Investment Ecosystem and Its Legal Underpinnings*, 14 J. LEGAL ANALYSIS 17 (2022).

93. Madison Condon, *Externalities and the Common Owner*, 95 WASH. L. REV. 1 (2020); Coffee, *supra* note 22; Robert G. Hansen & John R. Lott Jr., *Externalities and Corporate Objectives in a World with Diversified Shareholder/Consumers*, 31 J. FIN. & QUANTITATIVE ANALYSIS 43, 44 (1996).

94. *But see* Daniel Irvin, *Universal Owners, Shareholder Primacy, and Stakeholderism: How Should Universal Owners View Corporate Purpose?*, 10 EMORY CORP. GOVERNANCE. & ACCOUNTABILITY REV. 103, 118 (2022) ("Given that these spillover effects [of research and development] are often realized by firms in other industries, the Universal Owner realizes a greater benefit from firm [research and development] than a normal owner of the firm. This same basic dynamic is possibly present in other situations where a firm-level investment produces public goods, such as infrastructure and employee training.").

benefit, the universal owner can increase the value of its portfolio, even if there are distributional effects among portfolio firms.

If human capital is underproduced by firms, as Section I.B argues, then universal owners would want relatively greater production of human capital.

First, consider human capital investment decisions in a market structure containing two separately owned firms optimizing their own private financial payoffs. Each corporation bears all the costs of training workers, but they will not capture all of the benefits. A risk exists that the worker will move from one firm to the other firm after investment costs are sunk. The non-excludability problem produces incentives for the firm to reduce the amount of investment in development, training, and human capital management. Other things equal, firms would rather free-ride on the human capital investments made by the other firm, or by the public, than make their own costly investments in human capital management. When producing a public good, a separately-owned firm bears all the costs of production but only captures a slice of the benefits. Accordingly, separately owned firms have no incentive to produce public goods to the extent that the costs of production exceed that firm's individual private benefits from the public good. Under separate ownership, firms undersupply the public good of worker training, development, and human capital, just like markets.

Now consider human capital investments from the perspective of a market structure with a universal owner. The universal owner is generally indifferent as to whether the worker leaves Firm A and moves to Firm B (so long as the worker stays at a portfolio company and switching costs are low). From the universal owner's perspective, the human capital asset is merely transferred from one portfolio company to another, leaving the value of the portfolio undisturbed. Thus, the free-riding problems created by the non-excludability of human capital are removed relative to the separate ownership case. Unlike separate owners, universal owners have incentives to produce worker training and development that is efficient from a portfolio perspective.

The difference in the two examples is that when the common owner is making decisions, he or she actually internalizes all the relevant costs and benefits of investments in human capital. In contrast, under separate ownership, the decision-makers at each of the separate firms do not internalize any of the benefits that accrue to other firms. Thus, the common owner should be expected to make a decision that is closer to the socially optimal decision than compared to the case of separate ownership.

For the foregoing reasons, universal owners can be expected to demand high quality disclosures about human capital management from the firms in which they invest. This theory is consistent with the actual behavior of large

institutional investors, with some supporting evidence discussed in Section III.D. For reasons discussed further below, better information could help these investors more accurately price securities, make more informed voting decisions in director elections, and more effectively discharge their corporate governance functions of monitoring and engaging managers.

Adopting the perspective of a universal owner as a normative and legal decision-making framework is contested. Recently, a number of scholars have brought attention to the limitations of relying on universal owners to internalize negative externalities or otherwise advance social goals.[95] These critiques are persuasive and well made, even as some of these purported limitations are perhaps less persuasive in the context of human capital management compared to other contexts.

This Article uses the universal owner framework quite differently. The universal owner perspective is used as a normative and analytical benchmark for thinking about optimal disclosure rules, *not* whether disclosures will necessarily produce changes to corporate activity. The use of the information could be valuable for valuation purposes alone. In the disclosure context, the justification for adopting this universal owner perspective is primarily that it is the best framework to provide investors with the information that they need to help them make informed investment decisions and to ensure that securities markets are fair and efficient. Thus, the class of critiques arguing that universal owners are ill-suited to induce environmental or social change does not bear on the correct normative framework and decision-making criteria for mandatory *disclosure* rules under the federal securities laws.

B. Improving Investment Decisions

Empirical evidence exists supporting the conclusion that investors systematically misprice human capital when pricing equity securities traded in capital markets.[96] However, the size of this effect, if any, and the mechanisms for why human capital management is difficult to value are not well understood and are worthy of future study.

The relationship between human capital management and the financial performance of firms is not tenuous or speculative. Disclosures about human capital are a necessary and routine part of the disclosure package *already*

95. *See, e.g.*, Roberto Tallarita, *The Limits of Portfolio Primacy*, 76 VAND. L. REV. 511 (2023); Zohar Goshen & Assaf Hamdani, *Will Systematic Stewardship Save the Planet?* (working paper 2023); Lucian Bebchuk, Kobi Kastiel & Roberto Tallarita, *Does Enlightened Shareholder Value Add Value*, 77 BUS. LAW. 731 (2022); Amanda M. Rose, *A Hard Look at Portfolio-Focused Stewardship*, 2024 Colum. Bus. L. Rev. 313 (2024).

96. *See* Edmans, *supra* note 35, at 5.

demanded by potential acquirers in mergers and acquisitions transactions.[97] Depending on the deal, labor and compensation due diligence requests may include employee lists with title, compensation, job status, census demographics, and job descriptions; lists of independent contractor and consulting arrangements; performance reviews and disciplinary records; severance agreements and termination requests; employee policies, manuals, and handbooks; collective bargaining agreements; records of time sheets for employees; and any pending legal matters, including workers compensation claims and labor disputes. Human capital review is unquestionably an essential part of the due diligence process for acquirers. Potential acquirers use this due diligence information to inform the price they are willing to pay of various dimensions, including workforce productivity, legal risks, workforce compensation costs and incentives, among other matters. Periodic disclosures by public companies of similar information would be useful to investors in the capital markets for similar reasons as it is useful to potential acquirers in merger transactions. Put simply, investors are trading in the securities of public companies on an ongoing basis, and human capital disclosures would help them trade at more accurate prices.

What does the public goods perspective add to existing accounts about pricing efficiency? The public goods perspective points to three explanations for why investors might systematically misprice the value of human capital: information asymmetries, hold-up problems, and information costs of public goods, each emerging from the non-excludability characteristic of employment.

The first valuation challenge for outside investors relates to information asymmetries. If workers can flee, how can investors know whether the human capital currently at the firm will ultimately translate into financial returns? The workers themselves have better information about how they will deploy their human capital compared to investors. Credibly communicating the value of intangible assets from insiders to outsiders is difficult because of information friction. Investors have difficulty determining which firms will retain their human capital and which ones will not. Under this explanation, investors discount the price they are willing to pay for equity securities as a rational response to an adverse selection problem.

The second valuation challenge for outside investors relates to a hold-up problem. Because of the non-excludability problem, human capital can always flee. If a firm makes investments in human capital, it leaves them

97. David Harding & Ted Rouse, *Human Due Diligence*, HARV. BUS. REV. (Apr. 2007), https://hbr.org/2007/04/human-due-diligence.

vulnerable to opportunistic behavior by workers who can use their new skills to obtain higher compensation at a different firm. Indeed, the lack of control over workers is precisely why financial reporting standards do not permit firms to report human capital as an asset on the balance sheet.[98] Because of this hold-up problem, expected cash flows that accrue from human capital are not pledgeable to outside investors. Outside investors do not finance intangible assets because doing so leaves them vulnerable to opportunistic departures by workers. If a firm actually does overcome this hold-up problem by retaining workers with high job satisfaction, then the firm's operations over time will manifest consistent earnings beats.

The third valuation challenge is that the information production costs of human capital information are greater than other kinds of information. Most of the information produced by markets is transmitted by price signals. However, when there is a market failure, public goods like human capital go unpriced in markets. The information costs of valuing things like training, development, and employee satisfaction initiatives are relatively higher because there are no direct price signals assigned to those things by markets.

A final valuation challenge relates to systematic risk.[99] Suppose that a single portfolio company is causing mental health issues for a broad swath of the workforce. The productivity of all firms in the portfolio company would then be adversely affected as employees take more days off; show up to work sleep-deprived; leave work for office visits, and the like. In *McRitchie v. Zuckerberg*, plaintiffs advanced precisely this theory by alleging that Facebook's social media platforms were harming the labor productivity of other firms in the economy.[100] In that case, a Delaware judge dismissed the breach of duty allegations against the defendant directors, arguing that directors owe firm-specific fiduciary duties, not portfolio-specific ones. Disclosures about human capital management might better help investors evaluate systematic risks of this type.

Improved human capital disclosures can help investors bridge all three of these gaps with respect to pricing securities, making investment decisions, and engaging managers.

C. Improving Voting Decisions and Investor Engagement

Human capital disclosures enjoy support among advisors to institutional owners as it furthers their own corporate governance functions.

98. Honigsberg & Rajgopal, *supra* note 19, at 284.

99. *See supra* note 24.

100. *See* McRitchie v. Zuckerberg, 315 A.3d 518 (April 30, 2024).

For well-known reasons, proxy solicitations—seeking consent to vote shares on behalf of investors—are central to director elections.[101] Section 14 of the Exchange Act governs proxy solicitations by public companies.[102] Among other things, section 14 requires mandatory disclosures under certain conditions in connection with proxy solicitations.[103]

Mandatory disclosures about human capital in proxy statements can help inform investors in their first-order voting decisions. Investors want disclosures about the risks created by reliance on key persons and superstar CEOs, risks related to workforce retention, risks related to untapped productivity, and other human capital risks and opportunities. Put simply, the management of human capital is usually a key ingredient in the total mix of information that helps investors decide whether they want to vote for an incumbent or to support an insurgent. Moreover, mandatory disclosures in periodic reports and proxy statements can help investors in their ordinary monitoring and engagement activities. The beneficial owners of corporate stock, the investors, often have reason to monitor the performance of management and to engage them on issues that are important to them.

We know that human capital disclosures are important to large institutional investors because they tell us so. The Human Capital Management Coalition, a group of thirty-six institutional investors representing over $10 trillion in assets, has submitted various proposals supporting better quality human capital management disclosures.[104]

BlackRock Investment Stewardship describes its approach to human capital management disclosures in the following way:

> "We find it helpful when companies provide clear and consistent reporting on HCM matters to help investors to understand a company's approach to a potentially material business risk. We recognize that there are different reporting standards and frameworks on HCM, which may be voluntary or required by regulation. In such cases, we appreciate when companies provide context on their reporting and highlight the metrics reported that are industry- or company-specific."[105]

BlackRock, in its discussion of shareholder engagement with corporate governance, reasons that human capital management disclosures inform

101. *Id.* at 1204.

102. Securities Exchange Act of 1934 § 14, 15 U.S.C. § 78n.

103. *Id.*

104. *About the Coalition*, HUM. CAP. MGMT. COAL., https://www.hcmcoalition.org/about.

105. BlackRock Inv. Stewardship, *Our Approach to Engagement on Human Capital Management*, BLACKROCK, at 2, https://www.blackrock.com/corporate/literature/publication/blk-commentary-engagement-on-human-capital.pdf.

investors on matters involving firm competitiveness, risk management, and financial performance.[106]

On engagement with their portfolio companies, Blackrock counsels:

> "In our engagements, BIS focuses on understanding the effectiveness of boards and management in ensuring a company has the workforce necessary for delivering long-term financial performance. Our discussions cover material workforce related risks and opportunities, which may include how a company's business practices foster a diverse and inclusive workforce culture; enhance job quality and employee engagement; enable career development; promote positive labor relations, safe working conditions, and fair wages; and consider human rights."[107]

Similarly, Fidelity Investments asserts that "[w]e believe successful firms need human capital and talent management strategies that attract, motivate, and retain people with the diversity of skill sets and backgrounds required to fuel innovation and growth initiatives."[108] They also state that:

> "We believe people generate value. In our experience, no business can succeed over the long-term without the support of employees, customers, suppliers, and the communities in which it operates. We find issuers that carefully manage and invest in these key relationships build lasting resilience and competitive advantage."[109]

To be sure, some may be skeptical of institutional investors calling for increased human capital management disclosures. They might think that these calls manifest agency costs from intermediaries that are attempting to fight off fund regulation by appearing to operate "responsibly".[110] Others might argue that these intermediaries have their own ideological preferences that they are trying to impose on others and that regulators should not credit the preferences of fund managers. However, the speculative possibility that these agency costs exist, without more firm evidence, is probably not a good reason for managers or lawmakers to ignore what these investors say.

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106. For example, Blackrock Investment Stewardship claims that "many companies and investors consider robust [human capital management] to be a means through which to achieve a competitive advantage" and that "Companies need to be able to attract, retain, and develop workers with the skills and expertise necessary to execute their long-term strategy, meet the needs of their customers and others in their value chain, and deliver financial returns for shareholders. *Id.* at 1-2.

107. *Id*. at 1.

108. *Fidelity Investments Stewardship Principles*, FIDELITY INVS., at 3, https://www.fidelity.com/bin-public/060_www_fidelity_com/documents/about-fidelity/fidelity-stewardship-and-proxy-principles.pdf.

109. *Id.*

110. *See* Rose, note 8, at 1,825.

IV. DISCUSSION OF A MANDATORY HUMAN CAPITAL MANAGEMENT REFORM

The empirical data presented in Section II.B documents that existing mandatory disclosures are inadequate to support the objectives of the securities laws related to providing useful information to investors in an efficient manner about human capital management, at least in relation to leading proposals and the stated preferences of institutional investors. This Section shows how the public goods perspective advanced in this Article, together with other considerations, support a mandatory human capital disclosure rule and explains why the SEC has statutory authority to promulgate such a rule.

A. Statutory Authority to Promulgate a Human Capital Management Disclosure Rule

Any new mandatory rules promulgated by the SEC, including a human capital management disclosure rule, would likely be a focus of litigation in the post-*Chevron* judicial review world.[111] Of course, this concern would be mooted by Congress passing a law requiring mandatory disclosure of human capital information if it so desired.[112] Because obtaining new legislation is problematic, the focus initially is whether a path for the Commission to act exists. The best view is that the SEC has statutory authority to promulgate a human capital management disclosure rule, at least one that is broadly consistent with existing proposals on the table.[113]

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111. *See generally* Loper Bright Enters. v. Raimondo, 603 U.S. 369 (2024).

112. Some of the efforts by congress are described in *Human Capital Management Movement*, *supra* note 4, at 683-85.

113. I do not here consider constitutional challenges to mandatory disclosure of demographic information. One constitutional challenge could be on compelled speech grounds under the First Amendment. Sean J. Griffith, *What's Controversial About ESG? A Theory of Compelled Commercial Speech Under the First Amendment*, 101 NEB. L. REV. 876, 882 (2023). Separately, comply or explain disclosure rules related to demographic compositions of boards may raise Fourth Amendment issues. Notably, leading human capital management disclosure proposals do not contemplate including any such type of rule. The Nasdaq, a national securities exchange, recently created a listing rule that required listed companies to possess diversity on their board of directors or to explain through disclosures why they do not. Rule 5605(f), NASDAQ (2012), https://listingcenter.nasdaq.com/rulebook/. At present, the full Fifth Circuit is reconsidering a decision by a Fifth Circuit panel that sided with the SEC upholding the comply or disclose rule. Plaintiffs challenged the rule, claiming that it violated the Fourth Amendment of the United States Constitution and exceeded the SEC's authority. Notably, the comply or explain rule imposed by the Nasdaq may raise different constitutional issues than a hypothetical human capital management disclosure rule merely requiring disclosure of demographic information. Simone R.D. Francis, *DEI Under Scrutiny, Part XI: Fifth Circuit Reconsiders Nasdaq's Board Diversity Rule,* OGLETREE

When it enacted the Securities Exchange Act of 1934, Congress delegated broad authority to the SEC to safeguard investors and protect the integrity of the exchanges.

Under the Securities and Exchange Act, the SEC has the authority to require certain public companies to include in their registration statement as a public company "[s]uch information, in such detail, as to the issuer . . . as the Commission may by rules and regulations require, as *necessary or appropriate* in the public interest or for the protection of investors, in respect of the following:" regarding, among other things, "the organization, financial structure and nature of the [issuer's] business."[114] A separate provision of the Exchange Act provides the SEC authority to "prescribe *as necessary or appropriate* for the proper protection of investors and to insure fair dealing in the security," "such information and documents . . . as the Commission shall require to keep reasonably current the information and documents required to be included in or filed with [a] . . . registration statement," and (2) such annual and quarterly reports as the Commission may prescribe."[115]

Central to Congress's statutory design was its extension to the SEC of two independent grants of rulemaking authority so that the SEC could update and build on the mandatory disclosure system as time passed. The Securities Exchange Act of 1934 grants the SEC authority to promulgate rules for registrant disclosure "as necessary or appropriate in the public interest or for the protection of investors" (the "public interest authority" and the "investor protection authority," respectively).[116] Either of these authorities is sufficient to support the SEC's adoption of a human capital management rule.[117]

First, the SEC has the authority to adopt a human capital management rule "for the protection of investors."[118] The statute does not define the term "investor protection." But a core part of the design of the Securities and

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DEAKINS (July 17, 2024), https://ogletree.com/insights-resources/blog-posts/dei-under-scrutiny-part-xi-fifth-circuit-reconsiders-nasdaqs-board-diversity-rule.

114. 15 U.S.C.A. §§ 78*l*(b)(1) (emphasis added). In rulemakings requiring "public interest" determinations, the SEC must also consider whether the rule will promote efficiency, competition, and capital formation and the impact the rule would have on competition. *See id.* §§ 78c(f), 78w(a)(2).

115. 15 U.S.C.A. §§ 78m(a) (emphasis added).

116. Securities Exchange Act of 1934 §§ 3(b), 12, 13, 14, 15(d), and 23(a). Securities Exchange Act of 1934 §§ 3(b), 12, 13, 14, 15(d), 23(a); 15 U.S.C.A. § 77b requires the SEC to consider when it undertakes a rulemaking under its public interest authority, in addition to the protection of investors, whether the action will "promote efficiency, competition, and capital formation."

117. For an analysis of the SEC's authority to promulgate the recently proposed climate disclosure rule, *see* Letter from George Georgiev, Assc. Professor of L., Emory Univ. to U.S. Sec. & Exch. Comm'n 3 (June 20, 2021) (on file with SEC); *see also* letter from Jill E. Fisch, Saul A. Fox Distinguished Professor of Bus. L., on Behalf of Undersigned Law Professors, to U.S. Sec. & Exch. Comm'n 8 (June 11, 2021) (on file with SEC).

118. *See generally* Securities Exchange Act, *supra* note 116.

Exchange Act is to give investors the time and information they need to make informed investment and voting decisions and to maintain fair, orderly, and efficient securities trading markets. For the reasons described throughout this Article, human capital management information is undoubtedly among the information that is used by investors to make informed decisions. Human capital management information is a critical and routine part of mergers and acquisitions due diligence[119] and it's routinely demanded by large institutional investors.[120] Firm managers treat human capital like it's an asset.[121] The operational significance that managers place on human capital is corroborated by empirical studies showing the importance of human capital.[122] If disclosure for the "protection of investors" is to mean anything in the statute, it surely encompasses human capital management disclosures.

The SEC also has the authority to adopt a human capital management rule if it is "in the public interest."[123] As an initial textual matter, the "public interest" prong gives the SEC broad authority. "Public interest" is defined by contemporary dictionaries as "the general welfare and rights of the public that are to be recognized, protected, and advanced."[124] Congress chose to use "public interest" rather than "the interest of investors" or even a more limiting phrase like "the financial interest of investors."[125]

However, some might plausibly interpret the term "public interest" in the SEC's grant of authority more narrowly. The "public interest" prong is not an unlimited grant for the SEC to promote the public welfare, but is limited by the purposes of the Exchange Act: to promote informed investment and voting decisions by investors and to preserve the efficiency, integrity, and effectiveness of secondary trading markets.[126] The statutory language of "public interest" and "investor protection" may be interpreted as relating to the "complete and truthful exposure of all matters in relation to

119. *See* Harding & Rouse, *supra* note 97.

120. *See* BLACKROCK, *supra* notes 105-107; FIDELITY, *supra* note 108.

121. *See* Edmans, *supra* note 35.

122. *See supra* notes 33-39 and accompanying text.

123. *See generally* Securities Exchange Act, *supra* note 116. *See also* Cynthia A. Williams, *The Securities and Exchange Commission and Corporate Social Transparency*, 112 HARV. L. REV. 1197, 1201-03 (1999) (arguing that the SEC's public interest disclosure power is separate from and broader than its investor protection disclosure power and may include disclosures related to social accountability).

124. *Interest*, MERRIAM WEBSTER DICTIONARY, https://www.merriam-webster.com/dictionary/interest (last visited Nov. 3, 2024).

125. Nat. Res. Def. Council, Inc. v. Sec. & Exch. Comm'n, 606 F.2d 1031,1045 (D.C. Cir. 1979).

126. *Cf.* Yoon-Ho Alex Lee, Yoon-Ho, *Beyond Agency Core Mission*, 68 ADMIN L. REV. 551, 565-66 (2016).

the registrant's financial condition."[127] Human capital management disclosures still easily fit into the category of economic information that is important to investors because it relates to the registrant's financial condition. This Article presents ample evidence that sophisticated investors want human capital management disclosures in mergers and acquisitions transactions and in periodic disclosures of public companies.[128]

By this point, there should be no doubt that the SEC has the authority to issue a human capital management rule. But, if the reader or a judge has any doubt that the meaning of the statute encompasses SEC authority to promulgate a human capital management rule, then these doubts should be resolved in the SEC's favor because Congress delegated broad authority to the SEC when it enacted the Securities Exchange Act.[129] Congress explicitly delegated authority to the SEC in the Exchange Act to decide what disclosures are "necessary or appropriate" for the protection of investors.[130] As interpreted by the United State Supreme Court, the word "appropriate" entrusts an agency with "discretion" and "flexibility."[131] The District of Columbia Circuit has stated that Congress did not cast disclosure rules in stone but "opted to rely on the discretion and expertise of the SEC."[132] The legislative history also supports the idea that the Congress that passed the Securities Exchange Act of 1934 intended to grant the SEC broad discretionary authority to promulgate disclosure rules.[133] Congress also delegated discretionary authority to the SEC through the language authorizing the commission to regulate in the "public interest," which constitutes a residual category eligible for judicial deference to agency discretion even after *Loper Bright*.

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127. Bank of Am. Nat. Trust & Sav. Ass'n v. Douglas, 105 F.2d 100 (D.C. Cir. 1939).

128. *See supra* notes 119-122 and accompanying text.

129. *See* 15 U.S.C.A. § 78mm (granting the SEC authority to exempt "to the extent that such exemption is necessary or appropriate in the public interest, and is consistent with the protection of investors"); *id.* § 78(w)(a) (granting the SEC authority for making rules and regulations deemed "necessary or appropriate").

130. Loper Bright Enters. v. Raimondo, 603 U.S. 369, 400 (2024); 5 U.S.C.A. § 706 (West), ("[W]hen the best reading of a statute is that it delegates discretionary authority to an agency, the role of the reviewing court under the APA is, as always, to independently interpret the statute and effectuate the will of Congress subject to constitutional limits."). *See also* Adrian Vermeule, *The Deference Dilemma*, 31 GEO. MASON L. REV. 619 (2024).

131. *Loper Bright Enters*., 603 U.S. at 395 n. 6 (quoting Michigan v. EPA, 576 U.S. 743, 752 (2015).

132. Nat. Res. Def. Council, Inc. v. Sec. & Exch. Comm'n, 606 F.2d 1031,1045 (D.C. Cir. 1979).

133. *Id.* at 1051 (quoting H.R. Rep. No. 1383, 73d Cong., 2d Sess. 6-7 (1934) ("practically essential" for the SEC to have "broad discretionary powers"); S. Rep. No. 792, 73d Cong., 2d Sess. 5 (1934) (the SEC should have considerable latitude so that the securities laws did not become an "unworkable strait-jacket' regulation")).

Although various objections to the SEC's authority have been raised, they all fail. Here is the big one: the SEC oversteps its authority by mandating disclosures that have social implications because its statutory authority is limited to mandating disclosures about business and financial performance.[134] The best interpretation of a statute must look to the context, and, so the argument goes, the context of the Exchange Act does not permit rules that generate information with substantial social implications.[135] Some have even argued—solely on the basis of circumstantial evidence and speculation—that the SEC's climate disclosure rule is intended as a type of trojan horse designed to advance social issues through SEC rules.[136] The same charges could be leveled at a prescriptive human capital management disclosure proposal.

An objection that the SEC would overstep its role by issuing a human capital management disclosure rule is unpersuasive, even by the standard of critics of mandatory ESG disclosures. Human capital management is not merely a "divisive political topic[] of uncertain and inchoate corporate significance."[137] As demonstrated throughout this Article, human capital management is taught in foundational business school classes, it has existing treatment in accounting standards, and there is a plausible link between human capital management and financial performance.

More importantly, this objection is inconsistent with the "necessary and appropriate" language and other language in the SEC's broad grant of authority. The best reading of the Exchange Act is that Congress delegated discretion *to the SEC*, not to the courts, to determine whether the information

134. *See, e.g.*, Andrew N. Vollmer, *The SEC Lacks Statutory Authority to Adopt Climate-Disclosure Rules*, MERCATUS CTR. GEO. MASON UNIV. (Apr. 12, 2022); Cunningham Letter, *supra* note 15; Bernard S. Sharfman, *The Ascertainable Standards that Define the Boundaries of the SEC's Rulemaking Authority*, 3 U. CHI. BUS. L. REV. 193 (2024).

135. *See* FDA v. Brown & Williamson Tobacco Corp., 529 U.S. 120, 132–33 (2000) (arguing that the best interpretation of a statute may have to look to the context of the words). Nevertheless, and not necessarily as it specifically regards the climate disclosure rule, other commentators have claimed that social considerations might motivate at least some aspects of the securities laws. *See, e.g.*, Ann M. Lipton, *Not Everything Is About Investors: The Case for Mandatory Stakeholder Disclosure*, 37 YALE J. REG. 499 (2020); Donald Langevoort & Robert Thompson, *Publicness in Contemporary Securities Regulation*, 101 GEO. L.J. 337, 340 (2013) ("We suspect that some portion of what we call securities regulation follows from an effort to create more accountability of large, economically powerful business institutions that is only loosely coupled with orthodox (and arguably more measurable) notions of investor protection. This is the more general meaning of the term 'publicness'—what society demands of powerful institutions, in terms of transparency, accountability, and openness, in order for that power to be legitimate.").

136. *See* Vollmer, *supra* note 134, at 12 ("[t]he truth is that the objective of climate-change disclosures is predominately the policy goal of combating the causes of climate change and reducing fossil fuel emissions.").

137. Cunningham Letter, *supra* note 17.

is significant enough to the business and financial performance of firms and to the functioning of securities markets that it is in the public interest to mandate disclosures, even if those disclosures contain information that has social relevance. Given the "necessary or appropriate" language—language that represents the broadest and most expansive delegation of authority recognized in statutory interpretation—there is no plausible interpretation of the SEC's statutory authority that would permit a court to strike down a human capital management rule that required information about risks and opportunities to a company's business and financial performance, notwithstanding its nexus with important social and political issues.

These considerations have become a live issue as litigants have challenged the SEC's climate disclosure rule in the Eighth Circuit Court of Appeals, in part on grounds that the SEC lacked authority to issue the rule because the disclosures relate to an improper subject matter.[138] The precedent set in the Eighth Circuit on the climate disclosure rule will have important consequences for the system of mandatory disclosures under the securities laws.

The key issue raised in the climate disclosure litigation is where courts reviewing the SEC's statutory authority should draw the line on disclosures that produce *mixed* financial and nonfinancial information. No one denies that the SEC can mandate disclosures about financial information, such as financial statements. And no one asserts that the SEC can compel purely social disclosures, like the political opinions of managers. But what about mixed disclosures? True, some critics might concede that human capital management and executive compensation fall closer to the mix of more business and financial information and less social information that comes within the SEC's statutory authority. But they might argue, the climate disclosure rule falls closer to the mix of more social information and less business and financial information that it falls outside of the SEC's statutory authority.[139]

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138. Brief of Amici Curiae Americans for Financial Reform Education Fund, Environmental Defense Fund, Natural Resources Defense Council, Sierra Club, and Sierra Club Foundation in Support of Respondent, *State of Iowa, et al. v. SEC*, Nos. 24-1522, 24-1624, 24-1626, 24-1627, 24-1628, 24-1631, 24-1634, 24-1685, and 24-2173 (8th Cir. Aug. 15, 2024).

139. For example, the Cunningham Letter claims that the SEC has no authority to compel the creation and disclosure of any information for the purpose of inducing companies to modify their operational decision making. Cunningham Letter, *supra* note 17. The authors of this letter substantiate this claim, in part, by citing to 1975 administrative documents from the SEC staff claiming that "The SEC's experience over the years in proposing and framing disclosure requirements has not led it to question the basic decision of the Congress that, insofar as investing is concerned, the primary interest of investors is economic." Securities Act of 1933 Release No. 5569, (Feb. 11, 1975); Securities Exchange Act of 1934 Release No. 5627 (Oct. 14, 1975).

The human capital management case study shows that placing subject matter limitations on the SEC's disclosure authority—beyond the existing and ordinary requirement that the disclosure rules have some connection with the goals of the securities laws—goes too far. Much information required to be disclosed under federal securities laws has mixed financial and social relevance. For example, executive compensation disclosures might implicate contested political and social issues. Disclosures about material contracts might implicate social issues related to wages or environmental impact. If courts adopt a rule that the SEC's statutory authority extends solely to financial matters, the threads could unravel a large part of the existing mandatory disclosure system, undermining the effectiveness of the seamless system of mandatory disclosures in securities laws.[140]

I propose the following standard for interpreting the SEC's disclosure authority: if a disclosure rule rationally relates to commercial, financial, or business information and it does not affect corporate operations other than through disclosures, the SEC has statutory authority to promulgate it.

Critics of the climate disclosure rule have so far failed to set forth a workable standard, consistent with the meaning of the Exchange Act text, that would instruct courts how to determine that disclosures like human capital management and executive compensation fall within the SEC's statutory authority despite their social implications, while the SEC's climate disclosure rule does not fall within the SEC's authority. What line might courts draw? Perhaps they might say a disclosure rule is outside the SEC's statutory authority if it produces *predominantly* social information. But the statutory language of the Exchange Act provides no textual basis for imposing a predominantly financial test or any other similar test. Such a standard is inconsistent with the statutory language granting the SEC authority to provide "such other information" as it deems "necessary or appropriate" in the public interest or for the protection of investors.[141] Under

140. Indeed, critics of the SEC's climate disclosure rule draw out this extension. *For example,* Bernard Sharfman writes that:

> "Moreover, it would not be surprising to find that if an ascertainable standard review of all SEC rules and interpretations were to occur, many of them would be found to violate the boundaries of authority created by the identified standards. For example, the SEC takes the position that it has extremely broad authority to compel public companies to include shareholder proposals on social issues in their proxy statements. By taking this position, the SEC is showing a blatant disregard for the three ascertainable standards that permeate the Acts and the boundaries of authority that they create."

Bernard S. Sharfman, *The Ascertainable Standards that Define the Boundaries of the SEC's Rulemaking Authority*, OXFORD BUS. L. BLOG (Jan. 8, 2024), https://blogs.law.ox.ac.uk/oblb/blog-post/2024/01/ascertainable-standards-define-boundaries-secs-rulemaking-authority.

141. 15 U.S.C. §§ 77g(a)(1), 78*l*(b)(1). In making this determination, the SEC must consider whether the rule will promote efficiency, competition, and capital formation. *Id.* §§ 77b(b), 78c(f),

a *Loper Bright* analysis, the best reading of the Exchange Act is that Congress delegated to the SEC the discretion to make calls about what types of disclosures to compel, including disclosures of mixed financial and nonfinancial information. Case-by-case second-guessing by courts based on judicial views about social issues would violate the plain meaning of the Exchange Act text. It is possible that there is no line consistent with the Exchange Act that would enable courts to second-guess SEC disclosure rules so long as those rules, at least the disclosures, have a nexus with firm financial information or other information that advances the goals of the securities laws.

Some might further object by saying that the broad interpretation advanced here gives the SEC "limitless" ability to compel any disclosures they want, like "ordering filing companies to disclose the locations of dog parks near corporate properties or the average number of sunny days each year at corporate offices."[142] This claim is baseless. The best reading of the statute is that the SEC's disclosure authority is limited by the fact that mandatory disclosures must have some nexus with a firm's business or financial performance or some other goal of the Exchange Act. Moreover, the SEC's authority is limited by Congress and the President and all the constraints imposed by agencies through electoral politics. Of course, decisions about mandatory disclosure rules will be contested—otherwise, Congress would not have seen a need for a *mandatory* disclosure system. But questions about the boundaries of the package of mandatory disclosures are best left to expert rulemaking process and to the administrative and democratic accountability processes that accompany them.

Others will attack the proposal on the grounds that human capital management disclosures do not *really* protect investors. They say that demands for information from a vocal segment of the investment industry—and the most sophisticated investors, least deserving of the protections of the securities laws at that—provides a dubious basis for the SEC to exercise authority in the name of "investor protection." This policy argument fails to make a textual claim of how to best interpret the SEC's broad authority. But it even fails on policy as well. Many retail investors—the ones who most need investor protection—obtain protection not by reading disclosures themselves but by freeriding on the price efficiency and securities litigation threats brought by large, sophisticated investors.[143] Because disclosures work together as a seamless part of a system of mandatory disclosure and

78w(a)(2) (stating that the agencies enumerated in this section have the powers to make rules and regulations deemed "necessary and appropriate" to execute the functions vested in this statute).

142. *See* Vollmer, *supra* note 134, at 4.

143. Spamann, *supra* note 92, at 17.

with the regulation of securities intermediaries and other protections that facilitate efficient price discovery, it is dubious to treat disclosure requirements as inconsequential in isolation. Moreover, a critical piece of the effectiveness of this seamless disclosure system is the comparability of disclosures, and even sophisticated investors benefit from standardized disclosures. This general critique may bear on the wisdom of whether or not to include certain information in the package of mandated disclosures, but it should not go to the question of whether the SEC has the authority to promulgate rules in the first place.

A related objection that some might advance is that we simply cannot trust the demands by institutional investors for this information because of their own conflicts of interest, and thus, calls by institutional investors for certain disclosures should not be used as evidence that those disclosures will advance investor protection.[144] To the contrary, the objection goes, institutional investors want this information to advance their own personal, ideological agendas at the expense of fund beneficiaries. This critique, too, fails to make a textual argument. Nothing in the statutory text or its context suggests that the SEC's statutory disclosure authority is limited in any way by speculative and attenuated concerns about the agency conflicts of fund managers. The statute does not require the SEC to exhaustively analyze every possible conflict of interest faced by fund managers when promulgating disclosure rules. Fund managers are subject to direct regulation of conflicts of interest as fiduciaries and through other regulations. The SEC should not base general investor protection policy and disclosure policy on speculative and attenuated concerns about the agency costs of fund managers.

B. Policy Merits and Responses to Critics

1. The Policy Merits of Requiring Disclosures Involving Mixed Financial and Nonfinancial Information

The economic reason for requiring a mandatory human capital management disclosure proposal is the same as other justifications for mandatory disclosures: left to their own choices, companies will choose to disclose an amount of information below the socially optimal amount. A mandatory disclosure regime can improve on this market failure while reducing information costs.

Concern about how companies will utilize their discretion when making disclosures, together with concerns about the information costs to investors

144. Cunningham Letter, *supra* note 15.

of non-standardized disclosures, counsels for using a prescriptive system of mandatory disclosures rather than a principles-based system. The importance of prescriptive disclosures to investors also counsels against the use of materiality qualifiers for mandatory human capital management disclosures. Providing discretion over materiality determinations gives managers discretion to cherry-pick information, moving the system in the direction of more voluntariness.[145]

Of course, the details of any mandatory human capital management disclosure proposal are critical. A formal rulemaking that convenes a broad set of interested parties and goes through the notice and comment process and that complies with the requirements of the Administrative Procedures Act should be undertaken to hammer out the specifics of any proposal. A great starting point for lawmakers and regulators on such details is the "The Working Group on Human Capital Accounting Disclosure" proposal.[146] The scope and specificity of this proposal addresses many of the "fuzziness" concerns about other ESG proposals.[147] Since the Working Group's proposal is limited primarily to human capital expenditures, the SEC might look at other proposals related to human capital valuation.[148] Such a rulemaking process that contemplates prescriptive disclosures should weigh, among other things, the extent to which the disclosures advance the goals of the Exchange Act; the public benefits of the disclosures; whether the rule will contribute to event-driven litigation in an undesirable way; diversion of managerial attention; and other costs of disclosures.

The public goods perspective provides support to policy arguments for mandatory human capital management disclosures. Of course, mandatory disclosure rules are not necessarily the best tool to deal with market failures and public goods problems in general. Nor will mandatory disclosures be a sufficient tool to solve the human capital underinvestment problem.[149] But they still might be a helpful tool for the case of corporate investments in human capital. Giving a legal right to propertize a public good is often a better response to public goods problems compared to disclosure, as intellectual property does through patents. Government provision of a public good is also often a better response to a public goods problem compared to

145. *See, e.g.*, Rachel A. Thompson, *Reporting Misstatements as Revisions: An Evaluation of Managers' Use of Materiality Discretion*, 40 CONTEMPORARY ACCOUNTING RESEARCH 2,745 (2023) (providing evidence that some managers use materiality discretion opportunistically to report misstatements as revisions instead of restatements).

146. *See supra* notes 72-75.

147. *See* Rose, *supra* note 8.

148. *See, e.g.*, *Human Capital Management Movement*, *supra* note 4, at 731-33.

149. *See* Gadinis & Miazad, *supra* note 22 (arguing that disclosure of ESG issues is not enough to help companies achieve sustainability objectives).

disclosures. However, neither of those solutions is possible or desirable in the human capital management context. A lighter touch intervention like mandatory disclosure may not solve the problem, but it might help.

Perhaps the biggest concern from critics, even if it operates under the surface sometimes, is the idea that the SEC is overstepping its role if it compels disclosures that might implicate social issues.[150] The thorny conceptual question is whether the SEC should require disclosures that might generate *mixed* financial and nonfinancial information. The data presented in Section II.B shows that human capital management touches on some hot-button social issues, including diversity, human rights, and unions. Nevertheless, human capital management also indisputably touches on issues that are important to financial performance and firm valuation.

The human capital management case study shows that information that produces mixed financial and nonfinancial information *must* be the subject of mandatory disclosures if the SEC is to fulfill its mandate of providing decision-useful information to investors. Otherwise, mixed topics like executive compensation and human capital management disclosures—information that has very important financial consequences for firms—would be off limits for mandatory disclosures. These types of judgment calls on what information should be required for disclosure are well within the expertise and remit of the SEC to determine. The SEC ought to act relentlessly in pursuit of protecting investors and creating fair and efficient securities markets, even where their actions may have collateral consequences with respect to social issues. Congress can always reign in the SEC or specify its authority if it believes the SEC is getting the balance incorrect.

It is sensible to suggest that the SEC should not pass a new rule if there is not a good reason explaining why existing mandatory disclosures are not already producing adequate disclosures.[151] In particular, registrants already have obligations to disclose certain risk factors[152] and management's discussion and analysis of financial conditions and results of operation.[153]

150. Rose, *supra* note 8, at 1842; *see also* Paul G. Mahoney & Julia D. Mahoney, *The New Separation of Ownership and Control: Institutional Investors and ESG*, 2021 COLUM. BUS. L. REV. 840 (2021); A. A. Sommer Jr., Comm'r, SEC, Address at the Practising Law Institute: The Slippery Slope of Materiality, (Dec. 8, 1975), https://www.sec.gov/news/speech/1975/120875sommer.pdf (acknowleding that social activist groups are using federal disclosure laws as opportunities to advance their causes); Hester M. Peirce, Comm'r, SEC, Statement on Proposed Amendments to Modernize and Enhance Financial Disclosures (Jan. 30, 2020), https://www.sec.gov/news/public-statement/peirce-mda-2020-01-30 (arguing that "[w]e ought not step outside our lane and take on the role of environmental regulator or social engineer.").

151. Rose, *supra* note 8, at 1840.

152. 17 C.F.R. § 229.105.

153. 17 C.F.R. § 229.303.

Why, then, are existing requirements not producing adequate human capital management disclosures? For one thing, human capital does not fit neatly into existing financial reporting frameworks because employers cannot control workers the way they can control other assets, like factories. For the same reason, registrants may not discuss human capital in the management's discussion and analysis section. Moreover, many risks relating to human capital management, like untapped capacity risk and turnover risk, are passive and may not rise to the level of affirmative disclosures in the risk factors section. Nevertheless, information about untapped potential and turnovers may help investors assess valuation issues. Perhaps the most significant answer to the question of why a mandatory disclosure rule is important emerges from the empirical analysis in Section II.B. Existing disclosures by registrants, when they do occur, are varied and sometimes included with other unrelated disclosures, making it costly for investors to locate, interpret, and analyze the information. A mandatory disclosure rule could help produce standardized and comparable information.

Another concern is that ESG disclosure proposals could contribute to event-driven litigation and other securities litigation in an undesirable way.[154] Professor Rose calls the potential expansion of liability for companies, directors, and officers that would occur if issuers had to make disclosures in SEC filings "perhaps the biggest elephant in the room."[155] Undoubtedly, these are relevant factors. The securities laws are a complex, integrated body of law. Disclosure rules can affect private securities litigation in unexpected ways. But complaints about vexatious litigation and plaintiff-friendly rules sound in policy disputes that are tangential to the direct role of disclosures. The SEC must use its authority and judgment to advance the goal of providing investors with decision-useful information. If certain disclosures that are useful to investors create unfairness or imbalances in securities litigation, Congress can step in to change procedural or substantive rules, as it did in 2005 with the Private Securities Litigation Reform Act.

2. The Investor Choice Proposal

Professor Hirst has advocated making climate disclosures and certain other ESG disclosures a default rule with the ability of companies to opt-out

154. *See* Rose, *supra* note 8, at 1849-54 (arguing that event-driven securities litigation (lawsuits that claim corporate disclosures are misleading) have become more prevalent and harder to contest due to factual questions on materiality and scienter, and mandated disclosures could accelerate this trend).

155. *Id.* at 1847.

with investor approval.[156] This proposal has a distant ring with issuer choice proposals that sought to give issuers a choice about which securities law regime to adopt.[157] While this proposal has much to commend, it shares a deficiency with a purely voluntary regime: companies would have substantial freedom to choose their level of disclosure. Many of the same concerns about how companies would exercise this freedom would remain.[158]

The data presented in Section II.B revealing inconsistent and incomplete human capital management disclosures might be interpreted as undermining issuer choice proposals in this area. However, a primary difference of Professor Hirst's proposal compared to issuer choice proposals is that *investors*, not managers, would get the threshold decision of whether to opt out of the mandatory disclosure regime. Professor Hirst distinguishes his proposal from old issuer choice proposals by pointing to the evolution of stock ownership in the United States.[159] With the rise of universal owners, Hirst argues, we can trust that investors will make the optimal choice when deciding whether to opt-out of ESG proposals. Existing disclosures, like the ones reported in Section II.B, are initiated by *managers*, but Professor Hirst's proposal would give *investors* a threshold decision to remain in the mandatory regime.

But Professor Hirst's account is too optimistic as it relates to ESG disclosures. First, Professor Hirst's proposal is too reductive of ownership structure. The proposal appears to assume that *all* public companies are owned and controlled by a coalition of universal owners, or that the SEC can write a rule that acts as if companies are not controlled companies. Of course, the first claim is not accurate. Large public companies like Alphabet, Meta, Tesla, Dell, and many other public companies are controlled by insiders or concentrated owners.[160] This trend is not going away. The share of dual-

156. Scott Hirst, *The Case for Investor Ordering*, 8 HARV. BUS. L. REV. 227 (2018); Hirst, *supra* note 8.

157. On the issuer choice debate, *see* Roberta Romano, *Empowering Investors: A Market Approach to Securities Regulation*, 107 YALE L. J. 2359 (1998); Stephen J. Choi & Andrew T. Guzman, *Portable Reciprocity: Rethinking the International Reach of Securities Regulation*, 71 S. CAL. L. REV. 903 916-17 (1998); Stephen J. Choi & Andrew T. Guzman, *The Dangerous Extraterritoriality of American Securities Law*, 17 NW. J. INT'L L. & BUS. 207 (1996); Alan R. Palmiter, *Toward Disclosure Choice in Securities Offerings*, 1999 COL. BUS. L. REV. 1, 54-56; Paul G. Mahoney, *The Exchange as Regulator*, 83 VA. L. REV. 1453, 1498 (1997); Fox, *supra* note 6; Corrigan, *supra* note 6, at 1123.

158. *See also Market Essential Role*, *supra* note 22, at 2132 (arguing that allowing investors to opt-out of disclosures deprives the market of informational spillovers, reducing market efficiency).

159. *See* Scott Hirst, *The Case for Investor Ordering*, 8 HARV. BUS. L. REV. 227, 14-16 (2018).

160. Greg Iacurci, *Is the U.S. Stock Market Too 'Concentrated'? Here's What to Know*, CNBC (July 1, 2024), https://www.cnbc.com/2024/07/01/how-magnificent-7-affects-sp-500-stock-market-concentration.html. *Despite Selling Recently, Dell Technologies Inc. (NYSE:DELL) Insiders Own 46% Stake and Recent Decline Might Have Cost Them*, SIMPLY WALL ST. (Oct. 23,

class public firms is on the rise, not on the retreat. For companies that are controlled by insiders, the disclosure decisions would be similar to the ones made under a voluntary regime. In this case, the decision of investors collapses into the decision of insiders, and the insider controller would opt out of a mandatory rule whenever it was convenient or profitable to do so. Even if the SEC is capable of writing an opt-out disclosure rule that effectively disregarded dual class stock and other complex corporate governance arrangements that concentrate control, as Professor Hirst recommends, and is willing to expend the political capital to do so, this fiction would impose its own type of mandatory rule on private ordering, undermining many of the private ordering objectives purportedly motivating the opt-out proposal.[161]

Second, Professor Hirst's proposal understates the frictions of collective action and opportunistic behavior that might produce suboptimal opt-outs. The analysis throughout this Article supports the idea that universal owners have incentives to remain under a mandatory human capital management disclosure regime in principle. However, even these investors may ultimately support opting out of the mandatory disclosure regime. Since human capital management is only a small part of the total disclosure package, and because investor engagement is costly, investors are unlikely to push back against management that does not want to disclose human capital management issues. In some cases, insiders might also employ a divide-and-conquer strategy to advance their disclosure preferences, making side payments to key investors in exchange for voting to opt-out.[162] The practice of large investors in private funds to obtain information rights in side letters that are not shared with smaller limited partners is a cautionary tale of divide-and-conquer with respect to disclosures.

2024) https://simplywall.st/stocks/us/tech/nyse-dell/dell-technologies/news/despite-selling-recently-dell-technologies-inc-nysedell-insi.

161. Even Professor Hirst will not go as far as "disenfranchising" a controlling stockholder by proposing a majority of the minority requirement in controlled companies. Hirst, *supra* note 156, at 141-42 nn.278, 279. There is a tension in the proposal that dual class shareholders should be "disenfranchised" but other controlling stockholders should not. Regardless of whether there are any theoretical reasons to draw this distinction, the distinction would be challenged as an arbitrary and capricious one under the Administrative Procedures Act, create other legal challenges, and raise political challenges that the SEC may not be willing or capable of addressing.

162. For example, managers could agree to provide institutional investors with private disclosures and increased access. On the agency costs of institutional owners, *see* Lucian Bebchuk, Alma Cohen & Scott Hirst, *The Agency Problems of Institutional Investors*, 31 J. ECON. PERSP. 89 (Summer 2017) https://papers.ssrn.com/sol3/papers.cfm?abstract_id=2982617; Ronald J. Gilson & Jeffrey N. Gordon, *The Agency Costs of Agency Capitalism: Activist Investors and the Revaluation of Governance Rights*, 113 COLUM. L. REV. 863 (2013).

For the foregoing reasons, it is likely that at least some, and possibly many, public companies would opt out of a mandatory human capital rule. These companies would then be back in a voluntary disclosure regime. However, for the reasons described by Professor Coffee, voluntary disclosure regimes produce securities research below the optimal amount.[163] Moreover, substantial numbers of public companies opting out of the rule diminish comparability of disclosure and create duplicative research costs for investors.

V. CONCLUSION

This Article provides a theory for why human capital management disclosures are underproduced in markets. Markets underproduce investments in human capital because human capital is a public good. And, moreover, markets underproduce securities research about this underinvestment problem because securities research is itself a public good. The Article explains why large institutional investors want increased and improved human capital management disclosures and how these disclosures can help investors with their investment, voting, and engagement decisions. Finally, it provides empirical evidence supporting the claim that voluntary disclosure of human capital management information is inadequate.

The analysis supports proposals that would require standardized, comparable, and mandatory disclosures of human capital information. The Article argues that the SEC already has the authority to promulgate this rule and explains why such proposals have policy merits.

163. *See supra* note 6 and accompanying text.