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2150 Kittredge St. Suite 450
Berkeley, CA 94704
www.asyousow.org
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O'Reilly Automotive Inc. (ORLY)
Vote Yes: Item #6 – Material Human Capital Risks and Opportunities

Annual Meeting: May 14, 2020

CONTACT: Andrew Behar | abehar@asyousow.org

THE PROPOSAL

Shareholders request that the Board of Directors issue a report to shareholders describing the company's policies, performance, and improvement targets related to material human capital risks and opportunities by 180 days after the 2020 Annual Meeting, at reasonable expense and excluding confidential information, prepared in consideration of the metrics and guidelines set forth in the SASB Multiline and Specialty Retailers & Distributors standard's provisions on workforce diversity and inclusion and labor practices requirements.

RATIONALE FOR A YES VOTE

Human capital management disclosures are garnering attention in Congress[1] and the SEC.[2] Proponents are requesting human capital management disclosure that is financially material to investor decision-making. This disclosure concerns both diversity and inclusion, and fair labor practices.

Diversity reporting is financially material for O'Reilly Automotive's investors. As the Sustainability Accounting Standards Board (SASB) notes,

> [t]he Multiline and Specialty Retailers & Distributors industry is consumer-facing and relies on the ability to communicate effectively with customers during the sales process and adapt to changing consumer demands for products. As the populations of many developed markets undergo a massive demographic shift, including increases in minority populations, companies in this industry can benefit from ensuring that their company culture and hiring and promotion practices embrace the building of a diverse workforce at management- and junior-level positions. Retailers that respond to this demographic shift and employ staff who will be able to recognize the needs of diverse populations may be better able to capture demand from segments that have traditionally been overlooked, which can provide companies a competitive advantage. Furthermore, such companies may benefit from decreased legal and regulatory risks, as well as improved reputational value.[3]

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[1] Dana Wilkie, "Workplace May Be New Battleground for 2019-20 Congress," November 7, 2018. *Available at* https://www.shrm.org/hr-today/news/hr-news/pages/2018-mid-term-election-workplace-legislation.aspx

[2] Securities And Exchange Commission 17 CFR 229, 239, and 240 [Release Nos. 33-10668; 34-86614; File No. S7-11-19] RIN 3235-AL78. Modernization of Regulation S-K Items 101, 103, and 105. *Available at* https://www.sec.gov/rules/proposed/2019/33-10668.pdf

[3] MULTILINE AND SPECIALTY RETAILERS & DISTRIBUTORS, Sustainability Accounting Standard, Prepared by the Sustainability Accounting Standards Board, October 2018, p.16. *Available at* https://www.sasb.org/wp-content/uploads/2018/11/Multiline_and_Specialty_Retailers_Distributors_Standard_2018.pdf

The SASB has created financially material disclosure standards based on decision-useful, comparable metrics that allow investors to measure the impact of workforce diversity on operating performance and financial condition. The metrics referenced by the SASB standard are "[p]ercentage of gender and racial/ethnic group representation for (1) management and (2) all other employees," and "[t]otal amount of monetary losses as a result of legal proceedings associated with employment discrimination."

The SASB has also opined on the financial materiality of labor practices in the specialty retailer industry: "The low-average wages in the industry, which help companies maintain low prices on products, may increase…labor-related risks. Since customers regularly interact directly with employees, companies can face a decrease in market share and revenue from negative consumer sentiment due to public disagreement between companies and their workers."[4] The metrics referenced by the SASB Labor Practices standard are "[a]verage hourly wage and percentage of in-store employees earning minimum wage," "[v]oluntary and involuntary turnover rate for in-store employees," and "[t]otal amount of monetary losses as a result of legal proceedings associated with labor law violations."

The proposal requests nothing more than enhanced disclosure concerning financially material human capital management metrics. Investors deserve to be informed of these metrics so that they can appropriately evaluate the risks to our company from its human capital policies and procedures.

The Board's opposition to the Proposal centers on:

- Its belief that the Company's existing public disclosures **adequately** describe its approach to, and the importance to the Company of, **material** human capital risks and opportunities, including workforce diversity and inclusion and labor practices;
- The Company's commitment to workforce diversity and promoting an inclusive environment, also its commitment to sound labor practices;
- Its belief that the requested report would not provide sufficient benefits to justify the required time and expense, particularly in light of the information already available on the Company's website or otherwise publicly available.

The Company's commitments to workforce diversity and sound labor practices are appreciated and laudable. Unfortunately, O'Reilly's extant reporting doesn't satisfy the needs of investors who require material disclosure to monitor the progress of its human capital management practices.

Material disclosure is the basis of the Proposal, and the basis of federal securities law

Disclosure is the bedrock concept of federal securities law. As the Supreme Court has stated, "'[t]his Court "repeatedly has described the 'fundamental purpose' of the [1934 Securities Exchange] Act as implementing a 'philosophy of full disclosure.'"[5] The most salient aspect in considering whether disclosures are helpful to investors is related to materiality, a concept which has been considered "the

[4] *Id.* At 13.

[5] *Basic v. Levinson*, 485 U.S. 230 (1988).

cornerstone of the federal securities laws since Congress incorporated this principle in the first of these laws in the 1930s."[6]

The Supreme Court took up the definition of materiality in 1976's *TSC Industries v. Northway*.[7] The Court arrived at a definition of materiality that is now widely known:

What the standard does contemplate is a showing of a substantial likelihood that, under all the circumstances, the omitted fact would have assumed actual significance in the deliberations of the reasonable shareholder. Put another way, there must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available.[8]

The Court's exposition of materiality therefore highlighted that the essential aspect of the materiality test was that a fact be decision-useful in the eyes of the reasonable investor. Decision-usefulness necessarily implies comparability, as "…investment decisions essentially involve a choice between competing investment alternatives."[9] Comparability is stifled, however, in the absence of metrics.

The Increasing Materiality of Human Capital Disclosures

The SEC has recognized the increasing materiality of human capital disclosures. Last year, the Commission issued a release proposing for public comment amendments to modernize the description of business, legal proceedings, and risk factor disclosures that registrants are required to make pursuant to Regulation S-K.[10] Among the discussion topics proposed for "Narrative Description of Business," Item 101(c), were proposals for the modernization of human capital management disclosures. The Commission noted that, "[b]ecause human capital may represent an important resource and driver of performance for certain companies, and as part of our efforts to modernize disclosure, we propose to amend Item 101(c) to refocus registrants' human capital resources disclosures."[11] One important source for input on this matter is a report submitted by the SEC Investor Advisory Committee (IAC).[12] The IAC found that, "[i]nstitutional and retail investors have a pronounced interest in clear and <u>comparable</u> information about how firms approach [Human Capital Management]. <u>This interest is reflected in</u>

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[6] Business Roundtable, The Materiality Standard for Public Company Disclosure: Maintain What Works, 3 (Oct. 2015), http://businessroundtable.org/sites/default/files/reports/Materiality%20White%20Paper%20FINAL%2009-29-15.pdf

[7] *TSC Industries, Inc. v. Northway, Inc.*, 426 U.S. 438 (1976).

[8] *Id*. at 449; See also *Basic v. Levinson*, 485 U.S. 224, 232 (1988) ("We now expressly adopt the *TSC Industries* standard of materiality for the § 10(b) and Rule 10b-5 context."); *Halliburton Co. v. Erica P. John Fund, Inc.*, 134 S. Ct. 2398, 2413 (2014) (reaffirming this standard of materiality).

[9] 40 Fed. Reg. 51,662 (Nov. 6, 1975)

[10] SECURITIES AND EXCHANGE COMMISSION 17 CFR 229, 239, and 240 [Release Nos. 33-10668; 34-86614; File No. S7-11-19] RIN 3235-AL78. Modernization of Regulation S-K Items 101, 103, and 105, https://www.sec.gov/rules/proposed/2019/33-10668.pdf

[11] *Id*. At 48.

[12] Recommendation of the Investor Advisory Committee, Human Capital Management Disclosure, March 28, 2019. https://www.sec.gov/spotlight/investor-advisory-committee-2012/human-capital-disclosure-recommendation.pdf

ongoing projects by the Sustainability Accounting Standards Board (SASB) (emphasis added)."[13] Among the IAC's specific material disclosure recommendations were those concerning "the stability of the workforce, including voluntary and involuntary turnover," and "race/ethnicity and gender diversity data."[14] SEC Chair Jay Clayton, in addressing the IAC with reference to Human Capital Management, re-iterated that the Commission's disclosure requirements must be rooted in the principles of materiality and comparability, and noted that, "for human capital, I believe it is important that the metrics allow for period to period comparability for the company (emphasis added)."[15] Investors have a right to **material** and **comparable** Human Capital Management disclosure metrics from O'Reilly Automotive.

The dearth of metrics in sustainability disclosure has frustrated the reasonable investor

The SASB has produced a series of exhaustive analyses of U.S. issuers' financial disclosures.[16] It found that while most issuers already address most SASB topics in their filings ("73 percent of companies in the analysis reported on at least three-quarters of the sustainability topics included in their industry standard"),[17] "most sustainability disclosure consists of boilerplate language, which is largely useless to investors: The most common form of disclosure across the majority of industries and topics was generic boilerplate language, which is inadequate for investment decision-making."[18] Moreover, "[s]ustainability performance metrics are rarely disclosed and lack comparability when they are: Companies used metrics—obviously more useful to investment analysis—in around 29 percent of the cases in which a disclosure occurred. Importantly, even in these cases, the metrics were non-standardized and therefore lacked comparability from one firm to the next."[19] The SASB sums up the issue of ESG disclosure with the statement, "…by and large, companies continue to take a minimally compliant approach to sustainability disclosure."[20]

Investor frustration with the lack of metrics in sustainability reporting is palpable: According to PwC, "[m]ore than nine out of ten investors (92%) say companies are not disclosing ESG data in a way that makes it easy to compare to other companies..."[21]

Because the SASB's standards are exclusively concerned with comparable, material disclosures, they have attracted wide support from the investment community. The SASB Investor Advisory Group, 48 global asset owners and asset managers, includes seven of the world's ten largest investment advisers.

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[13] *Id*. At 2.
[14] *Id.* At 4.
[15] Remarks for Telephone Call with SEC Investor Advisory Committee Members, Chairman Jay Clayton, Feb. 6, 2019. *Available at:* https://www.sec.gov/news/public-statement/clayton-remarks-investor-advisory-committee-call-020619

[16] Sustainability Accounting Standards Board [SASB], State of Disclosure Report 2017, (2017) https://www.sasb.org/wp-content/uploads/2017/12/2017State-of-Disclosure-Report-web.pdf

[17] *Id*. at 2.
[18] *Id.*
[19] *Id*.
[20] *Id*. at 3.

[21] PWC GOVERNANCE INSIGHTS CENTER, INVESTORS, CORPORATES, AND ESG: BRIDGING THE GAP, 6 (Oct. 2016), https://www.pwc.com/us/en/governance-insights-center/publications/assets/investors-corporates-and-esg-bridging-the-gap.pdf.

Members of this group "[b]elieve SASB's approach—which is industry-specific and materiality-focused—will help provide investors with relevant and decision-useful information," and "[b]elieve that SASB standards can inform integration of sustainability factors into investment and/or stewardship processes, such as corporate engagement and proxy voting."[22] Members of the SASB Investor Advisory Group and SASB Alliance, "a growing movement of organizations that believe standardized, industry-specific, and materiality-based standards help companies and investors adapt to the market's expectations," comprise among others pension funds of six states.[23]

Clearly, disclosure that is not grounded in metrics, or relies on metrics that are not comparable, cannot meet the test of being decision-useful to the reasonable investor. If the Company's disclosure does not qualify as decision-useful in the eyes of a reasonable investor, then it does not meet the materiality standard requested by the Proposal. This point was thrown into sharp relief when O'Reilly requested that the SEC allow the company to exclude this proposal from the proxy on the basis that it had been substantially implemented.[24] The SEC was unable to concur with the exclusion.[25]

Material diversity proposals are supported by investors

Shareholder resolutions regarding diversity, and those explicitly referencing EEO-1 category percentage disclosures, receive increasing support over time. This table summarizes numbers of EEO-1 resolutions filed, and average level of shareholder support, that are available in the Ceres and Trillium databases by year since 2015:[26]

Year	Number of proposals filed	Average support level (%)
2015	3	24.4
2016	4	27.0
2017	9	32.4
2018	9	40.6
2019	5	42.6

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22 https://www.sasb.org/investor-use/supporters/
23 https://www.sasb.org/alliance-membership/organizational-members/
24 RE: O'Reilly Automotive, Inc. Securities Exchange Act of 1934 – Rule 14a-8 Exclusion of Shareholder Proposal of Terry L Miller, Debra Shank Miller, The Virginia Lopez Family Trust and Yu & Ho Liv Tr Sep Prop. *Available at* https://www.sec.gov/divisions/corpfin/cf-noaction/14a-8/2019/asyousowmillers122719-14a8-incoming.pdf
25 2019-2020 Shareholder Proposal No-Action Responses. *Available at* https://www.sec.gov/divisions/corpfin/shareholder-proposals-2019-2020.pdf
26 https://www.ceres.org/resources/tools/climate-and-sustainability-shareholder-resolutions-database; https://trilliuminvest.com/approach-to-sri/shareholder-proposals/?wpv-company=0&wpv-issue-type=workplace-diversity&wpv_filter_submit=Search

CONCLUSION

O'Reilly Automotive Company opposes issuing financially material disclosure that provides decision-useful investor protection as it serves the public interest. We therefore urge a **"Yes" vote for Proposal 6 on the 2020 O'Reilly Automotive Proxy Statement.**

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