Legal Update Article

Diversity in Boardrooms: Why Nasdaq Companies Still Need to Be Mindful Despite Recently Invalidated Rule

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Takeaways

- As the result of a Fifth Circuit decision on 12/11/24, Nasdaq-listed companies will not be required to provide demographic information about their directors.
- Companies should be alert to possible future state law requirements or investor interest in this area.
- Companies can consider assessing whether decision-making and risk mitigation would be enhanced by a more diverse board.

Related link

- Fifth Circuit opinion: 21-60626-CV0.pdf

Article

In a 9-8 *en banc* decision, the U.S. Court of Appeals for the Fifth Circuit overturned a three-judge panel decision and invalidated the Nasdaq Board Diversity Rule, Rule 506, that had been approved by the Securities and Exchange Commission (SEC). On Dec. 11, 2024, the court ruled the Diversity Rule is not consistent with the purposes and requirements of the Securities Exchange Act of 1934 and vacated the SEC approval. The court pointed out, however, that nothing prevents companies from voluntarily disclosing demographic information about their directors.

Facts

The Diversity Rule had two components:

1. It required companies listed on Nasdaq's U.S. stock exchange to provide a demographic breakdown of the company's board of directors as relates to a director's self-identified gender, race, and LGBTQ+ status.
2. It established a standard that each company should have at least one self-identified female director and at least one director who self-identified as a racial or ethnic minority, or as LGBTQ+. If a company did not meet the standard, it was required to provide a brief explanation as to why the standard had not been met. Nasdaq would not assess the sufficiency of the explanation; only whether it had been provided.

Nasdaq also proposed, and SEC approved, a Recruiting Rule under which Nasdaq would provide a complimentary board recruiting service to companies that did not meet the board diversity standard and requested the assistance. The Recruiting Rule was also challenged, but that part of the appeal was denied as moot because the recruiting service offer had expired, and no company was receiving the service.

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Under the Act, as a SEC-registered stock exchange, Nasdaq is a self-regulatory organization (SRO). SROs may not change their rules without SEC approval. The SEC must approve an SRO's proposed rule if — but only if — the SEC finds the rule consistent with the purposes of the Act.

The SEC found the Diversity Rule was consistent with the Act, because it was "designed to promote just and equitable principles of trade, remove impediments to and perfect the mechanism of a free and open market and a national market system, and protect investors and the public interest" as specified in the Act, among other things.

Arguments

The plaintiffs were Americans for Fair Board Recruitment, which has the stated mission of promoting the recruitment of corporate board members without regard to race, ethnicity, sex, and sexual identity, and the National Center for Public Policy Research, which is an independent conservative think tank. The plaintiffs argued that the Diversity Rule should be invalidated for two reasons:

1. The SEC's role in approving the Diversity Rule constituted government action that required analysis under the Constitution's Equal Protection clause; that because the Diversity Rule relied on gender and racial classifications, strict scrutiny was required, and the Diversity Rule did not pass strict scrutiny because it did not serve a compelling government interest and was not narrowly tailored.
2. The Diversity Rule was inconsistent with the Act.

A three-judge panel of the Fifth Circuit ruled that the SEC's role in determining whether the Diversity Rule was consistent with the Act did not rise to the level of government action triggering Equal Protection analysis. Upon petition of the plaintiffs, the Fifth Circuit granted *en banc* review and held oral arguments.

Court Opinion

The full Fifth Circuit overruled the panel decision and invalidated the Diversity Rule. After reviewing the history of the Act, the court ruled that the Diversity Rule was inconsistent with the Act and, since the issue could be resolved on statutory grounds, declined to address the Constitutional arguments.

According to the majority opinion, the Act's disclosure provisions are limited to "the kinds of information that are most likely to eliminate fraudulent and speculative behavior" and the Act is directed to "preventing market abuses." In other words, in the Fifth Circuit's view, the Act is limited to preventing abuses in the exchange of securities. The court noted, "Equipping investors to make investment and voting decisions might be a good idea, but it has nothing to do with the execution of securities transactions."

The Act's direction to the SEC to "promote just and equitable principles of trade" requires "exchanges to promote ethical behavior," but the court reasoned, it is not unethical for a company to decline to disclose information about the racial, gender, and LGBTQ+ characteristics of its directors.

Nasdaq announced it does not intend to appeal the decision. In view of impending changes in SEC leadership, it is unlikely the SEC in the incoming administration will appeal, so the litigation is effectively ended.

Impact on Employers

1. Nasdaq-listed companies will no longer be required to provide demographic information about their directors.
2. The court expressly left open the possibility of future state law requirements in this area, so companies should be alert to state legislation.
3. The court noted, "Nothing prevents companies from voluntarily disclosing — or even advertising — their directors' social demographic, political, or any other characteristics," so companies could consider whether such voluntary disclosures would be advantageous.
4. Companies should be alert to investor interest in director demographic disclosures, which Nasdaq cited as one reason for proposing the Diversity Rule.
5. Companies with low or no participation of women or minorities on their boards should consider assessing (a) whether there are unknown barriers to more diverse representation and (b) whether the company's decision-making and risk mitigation would be enhanced by a more diverse board.

Please contact a Jackson Lewis attorney if you have any questions.