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Fifth Circuit Court of Appeals Rejects Challenge to Nasdaq's Board-Diversity Rules

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The U.S. Court of Appeals for the Fifth Circuit denied review of the Securities and Exchange Commission's approval of proposed rules promulgated by the Nasdaq Stock Market concerning the diversity of directors on Nasdaq-listed companies' boards. The rules require listed companies to disclose director-diversity information and either to have a certain number of diverse directors or to explain why not. The decision in *Alliance for Fair Board Recruitment v. SEC* held that the rules do not violate the Constitution and that the SEC did not violate its statutory obligations in approving them.

The Nasdaq rules do not require board diversity; they require only disclosures and explanations. But the need to comply with the rules could have the practical effect of increasing diversity on boards of Nasdaq-listed companies.

Background

In August 2021, the SEC approved Nasdaq's proposal to adopt a listing standard designed to promote greater diversity on boards of Nasdaq-listed companies and to require diversity-related disclosures for those companies. Nasdaq's board-diversity rules, in their current form, require listed companies to publicly disclose board-level diversity statistics annually, using a standardized template, and to "have, or explain why [they do] not have," diverse directors.

Companies listed on Nasdaq before August 6, 2021 must have one diverse director or provide an explanation by December 31, 2023, and must have two diverse directors or provide an explanation by December 31, 2025 (for Nasdaq Global Select or Global Market companies) or December 31, 2026 (for Nasdaq Capital Market companies). Companies listed on or after August 6, 2021 have until one year from the listing date to provide the initial diversity matrix and one or two years from listing (depending on the type of company) to have one or two diverse directors or to provide the requisite explanation.

Operating companies with five or more directors can satisfy Nasdaq's diversity objective "with one female director and one director who is an underrepresented minority or LGBTQ+." Nasdaq provides "additional flexibility" for Smaller Reporting Companies, Foreign Issuers, and all companies with five or fewer directors. Smaller Reporting Companies and Foreign Issuers "can meet the diversity objective by including two female directors"; "all companies with five or fewer directors . . . can meet the diversity objective by including one diverse director."

The Alliance for Fair Board Recruitment (a nonprofit organization that has challenged other board-diversity requirements) and the National Center for Public Policy Research petitioned for review of the SEC's approval of Nasdaq's proposed rules, arguing that the rules are unconstitutional under the First and Fourteenth Amendments and that the SEC's approval violated the agency's statutory obligations under the Securities Exchange Act and the Administrative Procedure Act. The Fifth Circuit denied the petition for review.

The Court's Decision

The court first rejected petitioners' constitutional claims because "the Constitution only applies to state action," and Nasdaq's adoption of the rules did not constitute state action.

- The court held that Nasdaq is a private entity, not a state actor. "While Nasdaq must register with and is heavily regulated by the SEC, . . . a private entity does not become a state actor merely by virtue of being regulated."
- The court also rejected petitioners' alternative argument that "the SEC's involvement with and approval of Nasdaq's Rules render the Rules subject to constitutional scrutiny." The rules could not be attributed to the SEC because, for three reasons, "a sufficiently close nexus between the State and the challenged action of the regulated entity" did not exist: (*i*) "exchange listing standards are not a traditional, exclusive public function"; (*ii*) the SEC did not compel Nasdaq to adopt the rules; rather, "Nasdaq came up with the proposed Rules on its own"; and (*iii*) the SEC did not act jointly with and was not otherwise "pervasively entwined" with Nasdaq such that Nasdaq's conduct could be attributed to the government; instead, "Nasdaq generated the Rules itself, and then submitted them to the SEC for approval, as required by statute."

The court next held that the SEC had not violated its duties under the Exchange Act.

- The SEC did not act improperly in considering what petitioners called "thesubjective belief and desire of a subset of investors" in approving the board-diversity rules. The SEC had "substantial evidence" – all that is needed – to support its findings, and the Exchange Act does not require the SEC to consider only "objective evidence" in deciding whether to approve a proposed rule.
- Whether the diversity disclosures are "material" for purposes of stating a securities-fraud claim is irrelevant, because "a disclosure rule can be related to the purposes of [the Exchange Act] . . . even if the SEC does not find that the disclosure rule is limited to information that would be 'material' in the securities fraud context." "The fundamental purpose of the Exchange Act is implementing a philosophy of full disclosure . . . – not just the disclosure of information sufficient to state a securities fraud claim." "Even without conclusive empirical evidence that board diversity helps or hurts corporate performance," the SEC could conclude that "board diversity information contribute[s] to investors' investment and voting decisions based on substantial evidence of industry demand for this information to use in managing funds."
- Nasdaq's proposal "is a disclosure rule, not a mandatory quota," and does not invade areas of corporate governance traditionally reserved for state regulation.
- The SEC's approval of Nasdaq's proposal did not violate the "major questions" doctrine because the SEC has clear authority under the Exchange Act to regulate disclosures in the securities field.

Finally, the court held that the SEC had not acted arbitrarily or capriciously, in violation of the Administrative Procedure Act, in approving the rules. The administrative record provided substantial evidence to support the SEC's findings that "[b]oard-level diversity statistics are currently not widely available on a consistent and comparable basis, even though [Nasdaq] and many commenters argue that this type of information is important to investors."

Implications

The Fifth Circuit's decision leaves the Nasdaq board-diversity rules in place, at least for now. The rules do not mandate board diversity and do not direct Nasdaq-listed companies to add diverse directors to their boards. They require only disclosures and explanations about board diversity (or lack of it).

Nasdaq does not view the explanation requirement as particularly onerous. Nasdaq listed various permissible explanations for any lack of diversity, such as "[t]he Company does not meet the diversity objectives . . . because it does not believe Nasdaq's listing rule is appropriate," "because it does not believe achieving Nasdaq's diversity objectives [is] feasible given the company's current circumstances," "because the Nominating Committee considers a variety of [factors]" for director positions, or "because the Nominating Committee is committed to ensuring that the Board's composition appropriately reflects the current and anticipated needs of the Board and the company." The Fifth Circuit therefore concluded: "The requirement that a company give *an* explanation is not a sanction that mandates compliance with the two-diverse-board-members benchmark. The only sanction is for giving *no* explanation at all."

However, as the SEC recognized, the disclosure rules "may have the effect of encouraging some Nasdaq-listed companies to increase diversity on their boards." Thus, as a practical matter, the rules conceivably could affect board composition in the real world.

The SEC's approval of the rules does not mean that the Commission (or the Fifth Circuit) took a position on the *efficacy* of diverse boards. In fact, although Nasdaq had concluded that "an extensive body of empirical research demonstrates that diverse boards are positively associated with improved corporate governance and company performance," the Fifth Circuit noted that "the SEC reviewed the studies cited by Nasdaq, as well as studies that the comments [on the proposed rules] referenced, and found that the results were 'mixed." The debate about the extent (if any) to which diverse boards affect corporate performance will continue.

The SEC's approval and the Fifth Circuit's decision also do not mean that the agency or the court necessarily viewed board diversity itself as subjectively positive. The Fifth Circuit held only that the SEC had sufficient evidence to determine that, "regardless of whether investors think that board diversity is good or bad for companies, disclosure of information about board diversity would inform how investors behave in the market" – and that Nasdaq therefore had a basis for adopting its proposed rule.

One cannot help wondering whether petitioners will seek and the full Fifth Circuit will grant *en banc* review of the unanimous panel decision. Commentators have noted that the panel consisted entirely of Democratic appointees, who constitute a relatively small minority of the *en banc* court. In light of the political leanings of petitioners and the politicization surrounding board-diversity issues, *en banc* review conceivably could produce a different outcome.

We also will see how companies that do not have diverse boards respond to the Nasdaq rules' explanation requirement. As noted above, Nasdaq appears to concede that a company can satisfy that requirement simply by saying that the company "does not believe Nasdaq's listing rule is appropriate" or that it considers a variety of factors in nominating directors. These potential explanations could be easy to give and could avoid the need to engage with harder substantive issues about diversity. But some investors might demand fuller, more pointed, less generic explanations.

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