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## Public Company Update

# Fifth Circuit Vacated Nasdaq Board Diversity Rules

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On December 11, 2024, the Court of Appeals for the Fifth Circuit<sup>1</sup> issued a decision in *Alliance for Fair Board Recruitment v. SEC* vacating the SEC's approval of Nasdaq's board diversity rules.<sup>2</sup> The rules required tabular disclosure of voluntary self-identified gender, racial characteristics and LGBTQ+ status of a Nasdaq-listed company's board of directors and required companies to have two directors who would be considered "diverse" or otherwise explain why they did not. As a result of the decision, Nasdaq-listed companies are no longer required to comply with these rules but may choose to retain certain board diversity disclosures on a voluntary basis. In the meantime, the Fifth Circuit's narrow interpretation of the SEC's authority could have broader implications for SEC rulemaking.

The *Alliance* case was decided by a nine-eight vote, reflecting a split court, and contrasts with the conclusion of the three-judge panel of the Fifth Circuit that rejected the challenges to the Nasdaq board diversity rules last fall. In *Alliance*, the court held that the SEC acted arbitrarily and capriciously and outside the bounds of its power when it approved the Nasdaq diversity rules, and determined that the SEC was unable to provide adequate support for its finding that the Nasdaq diversity rules were consistent with the requirements of the Securities Exchange Act of 1934, as amended (the Exchange Act), or related to the purposes of the Exchange Act.<sup>3</sup> The court's decision highlights that a rule proposed by a national securities exchange does not meet the burden for approval by the SEC solely by expanding the information required to be disclosed by public companies. Rather, a disclosure rule must have an underlying connection to the purposes of the Exchange Act, which the Fifth Circuit narrowly interprets.<sup>4</sup>

## Background

The Nasdaq diversity rules, approved by the SEC in August 2021, required Nasdaq-listed companies, subject to certain exceptions, to disclose publicly in an aggregated tabular format information on voluntary self-identified gender, racial characteristics and LGBTQ+ status of the company's board of directors. In addition, the rule required that Nasdaq-listed companies, subject to certain exceptions, have two directors who would be considered "diverse" or otherwise explain why they did not.

<sup>1</sup> The Court of Appeals for the Fifth Circuit encompasses Mississippi, Louisiana, Texas and the Panama Canal Zone.

<sup>2</sup> No. 21-60626 (5<sup>th</sup> Cir. 2024).

<sup>3</sup> *Id.* at 40.

<sup>4</sup> *Id.* at 39.

As a self-regulatory organization, Nasdaq requires approval from the SEC for any changes to its rules. Accordingly, Nasdaq must submit any new proposed rule to the SEC, which is then published for notice and comment. Following the conclusion of the notice and comment period, the SEC may approve or deny the proposal. The court explained in *Alliance* that, as a threshold matter, in order to approve a rule proposed by the exchange, the SEC must find that the proposal “is consistent with the requirements of” the Exchange Act by determining that it is “related to the purposes of the Exchange Act.”<sup>5</sup>

## Decision

In its opinion, the court in *Alliance* walked through the legislative history of the Exchange Act from its initial adoption in 1934 to its overhaul in 1975. The court pointed out that the Exchange Act was enacted to limit market manipulation, fraud and speculation and to curtail exchange competition in order to protect investors.<sup>6</sup> In 1975, the Exchange Act was modified to establish a national market system with the goal of promoting competition among exchanges.<sup>7</sup> While the court acknowledged that the Exchange Act had certain other ancillary objectives, it stated that “disclosure of any and all information about listed companies is not among them”<sup>8</sup> and further explained that the SEC’s finding that a particular rule expands disclosure is insufficient to establish a nexus between the rule and the purposes of the Exchange Act. Instead, the court noted that the SEC must find that the proposed rule furthers an “actual, enumerated [purpose]” of the Exchange Act.<sup>9</sup>

The court reviewed and dismissed each element of the SEC’s rationale for approving the rules. First, the court explored the SEC’s assertion that the Nasdaq diversity rules were related to the purposes of the Exchange Act because they were “designed to . . . promote just and equitable principles of trade.”<sup>10</sup> This requires exchanges to promote ethical behavior in the context of the securities profession, including, for example, disciplining members that do not abide by their contractual commitments or that violate the securities laws.<sup>11</sup> The court found that a company’s failure to provide board diversity disclosure is far removed from the ordinary application of what is considered unethical and, therefore, the SEC should not have concluded that the Nasdaq diversity rules were related to promoting just and equitable principles of trade.<sup>12</sup>

The court then reviewed the SEC’s argument that the Nasdaq diversity rules should be considered related to the purposes of the Exchange Act because they were “designed to . . . remove impediments to and perfect the mechanism of a free and open market and a national market system.”<sup>13</sup> The court walked through a narrow interpretation of what it means to promote free and open markets and the national market system’s role therein, explaining that the promotion of free and open markets must be related to the execution of a securities transaction. The court contended that an exchange rule could be considered to support free and open markets and a national market system “if it did anything that might plausibly reduce the transaction costs associated with executing a securities trade.”<sup>14</sup> The court found that solely providing investors with disclosure on which the investor may or may not base its investment decision does not relate to the execution of a securities transaction and therefore could not support a finding that the Nasdaq diversity rules were related to the Exchange Act’s purpose of promoting free and open markets and a national market system.<sup>15</sup>

<sup>5</sup> *Alliance for Fair Board Recruitment v. SEC*, No. 21-60626, at 4 (5<sup>th</sup> Cir. 2024).

<sup>6</sup> *Id.* at 16-17.

<sup>7</sup> *Id.* at 20-21.

<sup>8</sup> *Id.* at 22.

<sup>9</sup> *Id.*

<sup>10</sup> *Id.* at 23.

<sup>11</sup> *Id.* at 24.

<sup>12</sup> *Id.* at 25.

<sup>13</sup> *Id.* citing 15 U.S.C. § 78f(b)(5).

<sup>14</sup> *Id.* at 27.

<sup>15</sup> *Id.*

The court then addressed the SEC's finding that the Nasdaq diversity rules were designed to safeguard the public interest and protect investors. The court narrowly interpreted the exchange's ability to adopt laws promoting the public interest, explaining that the provision must be read in the context of neighboring statutory language. In the court's view, the key determination is whether the rule protects investors from "the kinds of harm that the Exchange Act explicitly lists as its targets—that is, speculation, manipulation, fraud, anticompetitive exchange behavior."<sup>16</sup> The court rejected Nasdaq's argument that there is a positive correlation between the quality of a company's corporate governance or disclosures and the diversity or lack thereof of its board of directors, and further provided that even if Nasdaq could prove such a correlation, it did not demonstrate a sufficient connection between investor protection and diversity.<sup>17</sup> The court also took issue with the framing of the rule, which required companies who did not meet the diversity criteria to disclose why. The court explained that investor protection could only be served if Nasdaq could show "a corporate-governance delta between (A) non-diverse boards that have no explanation for their non-diversity and (B) non-diverse boards that have "good" reasons for their non-diversity."<sup>18</sup>

Finally, the court applied the major questions doctrine to underscore its statutory interpretations. Underlying the major questions doctrine is the principle that agencies like the SEC only have the authority granted to them by Congress through the adoption of a relevant statute. Applying the major questions doctrine, the court found that the SEC "intruded into territory far outside its ordinary domain."<sup>19</sup> The court reviewed the economic and political significance of the rulemaking, sharing that the impact of the rules was equivalent to regulating the whole of the economy in an area that is hotly debated across political lines.<sup>20</sup> The court went on to say that in approving the Nasdaq diversity rules, the SEC exercised a novel and inappropriate use of its power, which is instead vested within the purview of other agencies and the states, and was not supported by "clear congressional authorization."<sup>21</sup>

### Key Takeaways

Board diversity disclosure started to appear in proxy statements a few years before the Nasdaq diversity rules were approved. Companies began voluntarily providing board diversity disclosure primarily in response to demands of certain institutional investors and in light of the diversity policies of proxy advisory firms Institutional Shareholder Services (ISS) and Glass Lewis. Each of ISS's and Glass Lewis's current proxy voting guidelines contain language indicating that the proxy advisory firm will recommend that stockholders vote against a nominating committee chair, or all members of the nominating committee, depending on the circumstances, if the company does not exhibit a minimum standard of gender and ethnic diversity.<sup>22</sup> Levels of board diversity also factor into ISS's Governance QualityScore and Glass Lewis's ESG Profile methodologies. While Nasdaq-listed companies are no longer required to provide board diversity disclosures in a prescriptive format, companies should consider their specific circumstances, including feedback from investors, in deciding whether there is a benefit to retaining diversity disclosures in a format of its choice, including on its website.

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<sup>16</sup> *Id.* at 28.

<sup>17</sup> *Id.* at 28-30.

<sup>18</sup> *Id.* at 30-31.

<sup>19</sup> *Id.* at 33.

<sup>20</sup> *Id.* at 34.

<sup>21</sup> *Id.* at 35-36.

<sup>22</sup> For Glass Lewis, the recommendations applies only to companies within certain indices. The ISS policy on gender diversity applies, to differing extents, regardless of a company's market capitalization.

This decision is the latest of a series of recent court opinions overturning SEC rulemaking, including the share repurchase rules and the private fund rules. In addition, the SEC's climate change rules are currently stayed, pending judicial review, and the SEC is unlikely to defend the rules under new leadership. This decision also highlights the Fifth Circuit's narrow interpretation of agencies' authority to make rules. To the extent that additional challenges are brought in the Fifth Circuit, there may be additional reversals of currently effective rules.



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