

GUEST COLUMN

5th Circuit vacates SEC approval of NASDAQ board diversity rules

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The Dec. 11, 5th Circuit en banc decision striking down NASDAQ's board diversity rules likely signals the end of the road for NASDAQ's embattled "diversify or disclose" requirements. A closely divided Court of Appeals for the 5th Circuit in *Alliance for Fair Board Recruitment v. SEC* (5th Cir.; 12/24), in a 9 to 8 decision, held that the SEC's approval of the rules exceeded its authority, reversing a 2023 decision by a 5th Circuit panel. The court found that the diversity rules were not a disclosure requirement, but "a public-shaming penalty" for failing to abide by the government's diversity requirements. Neither NASDAQ nor the SEC is likely to appeal the decision. This decision will not end board diversity disclosure, because the market players that pushed for it, as well as existing SEC disclosure requirements, will continue, but it does eliminate rules that ensured consistency in such disclosure for NASDAQ-listed companies.

Under 15 U.S.C. §78s(b), the SEC can only approve a self-regulatory organization (SRO) rule that is "consistent with the requirements of" the Exchange Act. The court interpreted this to mean the rule must be "related to" the Exchange Act's purposes, including preventing fraud, promoting just and equitable trade principles, and generally protecting investors and the public interest. The majority concluded that the board diversity rules flunked this test.



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The court broke down NASDAQ's rule proposals into components and focused on the "disclosure rule" and the "diversity rule." The disclosure rule requires listed companies to annually disclose board-level diversity data based on each director's voluntary self-identified characteristics in accordance with a prescribed "matrix." The diversity rule requires listed companies to have, or explain why they do not have, at least two diverse directors, including at least one female director and at least one underrepresented minority or LGBTQ+ director.

In concluding that both the disclosure rule and the diversity rule were "related to" the purposes of the Exchange Act, the SEC noted that board-level diversity information was important to institutional investors and others, that the rules make available "consistent and comparable" board diversity information, and that an explanation of why a company had not met the rule's diversity objectives would contribute to investors' investment and voting decisions. Accordingly, the SEC found that the rules were "designed to promote just and eq-

uitable principles of trade, remove impediments to ... a free and open market ..., and protect investors and the public interest."

The court, however, did not agree that the market's stated interest in board diversity information, even in relation to investment and voting decisions, empowered the SEC to approve SRO rules requiring disclosure of such information. It found that all disclosure rules are not de facto "related to" the purposes of the Exchange Act, noting that the Exchange Act's purpose is to protect against fraudulent practices

and to promote competition. The court concluded that the limited purposes set forth in 15 U.S.C. §78f(b)(5) were not related to the disclosure of the racial, gender, and sexual orientation characteristics of public company directors.

In rejecting the SEC's contention that the diversity rules are "designed to . . . promote just and equitable principles of trade," the court took the position that it was "not unethical for a company to decline to disclose information about the racial, gender, and LGBTQ+ characteristics of its directors." The court opined that making information available that may contribute to investment and voting decisions "...might be a good idea, but it has nothing to do with the execution of securities transactions." In rejecting the SEC's argument that the rules are designed "in general, to protect investors and the public interest," the court found NASDAQ offered insufficient support for "any link between investor protection and racial and sexual diversity." The court also found support under the "major questions doctrine," which provides that in cases involving "vast and comprehensive" impact, an administrative agency's authority is limited to what Congress has expressly provided. The court concluded that

the diversity rules raised major questions, and that express authorization was lacking, stating that "no part of the Exchange Act even hints at SEC's purported power to remake corporate boards using diversity factors."

The 8 dissenting judges had a different view of the SEC's role in approving the NASDAQ board diversity rules. The dissent stated that the SEC is not permitted to "displace NASDAQ's private business judgement" when evaluating a proposed listing rule. They noted that the SEC is obligated to approve exchange rules that are consistent with the Exchange Act's purposes, which under well-established caselaw, include a "philosophy of full disclosure." The dissenters observed that the diversity rules eliminate information asymmetries with respect to board diversity data between large investors, who have the market power to directly obtain the desired information, and smaller investors, who must "rely on incomplete public disclosures." The dissent noted that the SEC should not question the market's judgment in seeking disclosure of board diversity information.

Many commentators have cited this decision as another "nail in the coffin" of corporate DEI programs. It follows a current trend for courts

to narrowly interpret agency authority, and a policy trend limiting companies' focus on DEI initiatives. Interestingly, the fact that the NASDAQ board diversity rules did not mandate diversity, only disclosure, did not save them from being overturned.

However, this does not sound the closing bell for board diversity disclosure. Current SEC proxy rules require disclosure as to whether and how the nominating committee (or the board) considers diversity in identifying director nominees, and if such a policy ex-

ists, how it is implemented and its effectiveness is assessed. Companies must also explain the specific experience, qualifications, attributes, or skills of nominees.

Moreover, the institutional investors who initially pressed for board diversity information will likely continue to push for disclosure of this information. Going forward, decision-making around board diversity and related disclosure will revert to market participants with significant leverage, risking the informational asymmetries about which the dissent warned.

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