

NASDAQ CONCEDES INVALIDATION OF BOARD DIVERSITY RULE BY DIVIDED FIFTH CIRCUIT EN BANC

Dec 12, 2024

WHAT HAPPENED

Yesterday, in a 9-8 ruling, the Fifth Circuit invalidated the SEC's approval of the Nasdaq board diversity rule in [Alliance for Fair Board Recruitment v. SEC](#). Invoking the "major questions" doctrine, the court ruled the SEC lacked statutory authority in 2021 to approve the rule in light of the perceived limited purposes of the Exchange Act.

TAKEAWAYS

The SEC has not announced whether it plans to appeal. However, Nasdaq notified listed companies this morning:

"We respect the Court's decision and do not intend to seek further review. As a result, companies will no longer be required to follow Nasdaq's board diversity disclosure rules.

The SEC itself only approved the rule by a 3-2 vote along partisan lines. With the upcoming change in presidential administrations and SEC commissioners, revival of the rule may be unlikely.

DEEPER DIVE

As discussed in our August 6, 2021 post ([It's Official: SEC Approves Nasdaq Board Diversity Proposal – Comply or Explain Why Not](#)), Nasdaq required listed companies, subject to transition periods:

- To publicly disclose information on the voluntary self-identified gender and racial characteristics and LGBTQ+ status of the company's board of directors, subject to certain exceptions.
- Present the information in a board diversity matrix on an aggregated basis by specified characteristics.

- Subject to certain exceptions, have at least two members of its board of directors who are “diverse” (as defined), including at least one director who self-identifies as female and at least one director who self-identifies as an underrepresented minority or LGBTQ+.
- If a company does not have such diverse directors, it must provide an explanation for not doing so, which could include a description of a different approach.

As noted by [Bloomberg Law](#), one of the groups challenging the rule is led by Edward Blum, who also spearheaded the case against affirmative action in the 2023 Supreme Court decision.

The Fifth Circuit ruling echoed some of the reasoning in the dissents of the conservative members of the SEC in 2021: [Hester Peirce](#) and [Elad Roisman](#).

Rule deemed unrelated to purposes of Securities Exchange Act

In the court’s view, the Exchange Act “exists primarily to protect investors and the macroeconomy from speculative, manipulative, and fraudulent practices, and to promote competition in the market for securities transactions.” A disclosure rule must have some connection with those purposes. It found those purposes bear no relationship to the Nasdaq rule requiring disclosure of information about the racial, gender, and sexual characteristics of directors.

In particular, the court found that the proposal is not related to requirements in the Act for exchanges to adopt rules designed to promote:

- “Just and equitable principles of trade.”
 - The court viewed this purpose as relating to the conduct of registered members (broker-dealers).
- “Remove impediments to and perfect the mechanism of a free and open market and a national market system.”
 - The court viewed this purpose as relating to markets for securities transactions.
- “Protect investors and the public interest.”
 - Applying canons of statutory interpretation, the court found that this broad language is limited to the general purposes of the Exchange Act, namely, “speculation, manipulation, fraud, anticompetitive exchange behavior, &c.”
 - The court found that Nasdaq failed to demonstrate “[any] link between the reason for the lack of racial, gender, and sexual diversity on a company’s board and the quality of its governance.”

- The SEC justified the proposal as responsive to the demand of various institutional investors; however, the court deemed that rationale as outside the scope of purposes of the Act.

Major questions doctrine viewed as supporting focus on statutory purposes of Exchange Act

The court found that the Supreme Court's major question doctrine "confirms" its ruling. That doctrine requires an agency to identify "clear congressional authorization" when it asserts power to take action that has sufficient "economic and political significance" (i.e., a major decision).

According to the court:

- The economic significance is represented by the status of Nasdaq as the second-largest stock exchange in the world.
- The political significance is "staggering," as the focus on increasing diversity and inclusion among public companies is one of the "more politically divisive issues in the Nation."
- The SEC action is "novel," lacking historic precedent, and extends beyond its "ordinary regulatory domain of market manipulation and proxy voting." In its view, the SEC intruded into an area traditionally governed by the states.

In its view, the Exchange Act fails to provide support for the SEC's action to approve the rule.

DISSENT

According to the dissent:

- Nasdaq adopted the rule in response to feedback from investors and public companies that information about the characteristics of the board was not standardized or efficient to collect.
- The SEC is *required* to approve "*private ordering* through rules proposed by *self-regulatory organizations*" when consistent with the Exchange Act.

In its view, the court improperly constrains SRO authority by preventing Nasdaq from "eliminat[ing] information asymmetries regarding board leadership – the very leaders entrusted with investors' money and whose identify investors across the full spectrum of our economy seek."

The dissent believes the rule sufficiently relates to maintaining "fair and orderly markets" by making available important information not widely available on a consistent and comparable basis. That data would "contribute to investors' investment and voting decisions" and reduce "information asymmetries between larger stakeholders, who are able to collect [diversity] data directly from companies, and smaller investors, who must rely on incomplete public disclosures."

The dissent also rejected the invocation of the major questions doctrine, noting:

- The petitioners “abandoned that argument at the en banc stage.”
- The earlier panel opinion explained why this isn’t a major questions case.
 - The SEC’s asserted authority is “unremarkable.”
 - The rule is not economically or politically significant enough.
- The majority implies that the SEC should have exercised *more*, not less, of its limited authority to disapprove the rule. Moreover, the Exchange Act expressly requires that it approve Nasdaq’s disclosure-based framework if it is “consistent with the requirements of [the Exchange Act].”

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