



Current Nasdaq rules require companies listed on Nasdaq to publicly disclose information on the gender and racial composition and the LGBTQ+ status of their boards of directors. The rules, designed to encourage more transparent and consistent disclosure of board composition and to increase the diversity of corporate boards, were immediately challenged by two conservative groups.

In an October opinion, the U.S. Court of Appeals for the Fifth Circuit – in [\*\*\*All. For Fair Bd. Recruitment v. SEC\*\*\*, No. 21-60626, 2023 WL 6862856 \(5th Cir. Oct. 18, 2023\)](#) - firmly rebuffed this challenge in a strong vindication of Nasdaq's right to adopt, and the SEC's authority to approve, rules furthering diversity. The decision should further encourage progress toward the representation of women, racial minorities, and LGBTQ+

persons on the boards of Nasdaq-listed companies.

## **The Nasdaq Rules**

In August 2021, the SEC approved the rules, which require Nasdaq-listed companies to publicly disclose certain information on the gender and racial composition and the LGBTQ+ status (all self-identified) of their boards of directors.

Listed companies are also required to have at least two directors who are "Diverse," as defined in the rules, including one self-identified female and one self-identified "Underrepresented Minority," or to explain why they did not. An "Underrepresented Minority" is one who self-identifies in one or more of the following categories: Black or African American, Hispanic or Latinx, Asian, Native American or Alaska Native, Native Hawaiian or Pacific Islander, or two or more Races or Ethnicities. We discussed the rules in depth in "[5 Things to Know About Nasdaq's Board Diversity Disclosure Requirement.](#)"

## **The Lawsuit**

Two conservative groups, the Alliance for Fair Board Recruitment (AFBR) and the National Center for Public Policy Research (NCPFR), promptly petitioned for review of the SEC's approval by the Fifth Circuit. In its detailed opinion issued October 18, 2023, the Fifth Circuit denied their petition, finding that:

- Nasdaq is not subject to constitutional constraints under the First or the 14th Amendments because it is neither a "state actor," nor so entangled with the SEC through the approval process for the rules that it should be treated as a state actor; and
- The SEC's approval of the rules did not exceed its authority under the Exchange Act.

In reaching its decision, the Fifth Circuit made several important points.

### **Nasdaq Is Not a "State Actor" Subject to Constitutional Constraints**

Petitioners argued that Nasdaq's adoption of the rules violated the First and the 14th Amendments to the U.S. Constitution. The Court found that neither provision applied because Nasdaq is a private entity—not a state actor.

The Court noted that Nasdaq was not created by statute and is not funded by the U.S. Government: It is a limited liability company wholly owned by Nasdaq, a public company. Its board is selected by its broker-dealer members and by Nasdaq, not by the U.S. Government. To list on Nasdaq, companies enter into individual contracts with Nasdaq. Although Nasdaq, like other self-regulatory organizations, must register with and have its rules approved by the SEC, it does not "operate under the direction or control of the SEC" in a manner that would constitute it as a state actor.

Petitioners argued alternatively that the SEC's review and approval of the rules made them "fairly attributable to the State" and therefore subject to constitutional scrutiny. The Court found that the approval process did not constitute the "close nexus" between Nasdaq and the government needed to attribute its action to the state.

In adopting the rules, Nasdaq was not performing a "traditional, exclusive public function," according to the Court. It noted that stock exchanges existed as "private associations regulating their own members before the SEC was created;" that the SEC did not compel Nasdaq to adopt the rules - Nasdaq initiated the process without SEC involvement; and that Nasdaq did not "act jointly" with the SEC. The SEC's "yes-or-no" approval process did not "entwine[]" Nasdaq with the SEC such that Nasdaq's adoption of the Rules constituted state action.

## **The SEC Appropriately Considered the Subjective Opinions of Investors In Approving the Rules**

Petitioners next argued that the SEC's approval of the rules exceeded its authority under the Exchange Act.

NCPPR first argued that the SEC improperly considered the "subjective beliefs" of investors in approving the rules, but was required by the Exchange Act to consider only "objective evidence" (without explaining the difference between "subjective" and "objective"). The Court found no such limitation in the Exchange Act, which states that the SEC's findings of fact are conclusive "if supported by substantial evidence"; that is "such relevant evidence as a reasonable mind might accept to support a conclusion."

In its review, the SEC considered a multitude of investor comments on the rules. The Court concluded that, although "[t]he SEC must independently analyze investor comments . . . the subjective opinions of those investors may be relevant evidence and sufficient to meet the substantial evidence standard, as they are here."

## **The Exchange Act Does Not Limit Disclosure Provisions to "Material Information"**

Petitioners also argued that a disclosure requirement under the Exchange Act "must be limited to 'material' information," utilizing the materiality test employed in securities fraud claims. That test is met "if there is a substantial likelihood that a reasonable investor would consider the information important in making a decision to invest." Petitioners asserted that "information regarding directors' race, gender, and sexuality is not material" under that standard. But the Court found that a disclosure rule need only be "related to the purposes of [the Exchange Act]," which does not limit such rules to "information that would be 'material' in the securities fraud context."

Furthermore, the Court found that determining fraud materiality is "peculiarly within the competence of the trier of fact" and imposing such a materiality requirement in a rulemaking context, without a specific set of facts to examine, would be unworkable.

The Court reasoned that "[t]he SEC did not need to find that there is an empirical or scientific basis about the effects of board diversity" and noted that "studies of the effects of board diversity are generally inconclusive." But the SEC's consideration of these studies "alongside substantial evidence that many investors already use board diversity information to make investments, are consistent with a finding of materiality—assuming that it is even possible to make such a finding outside the context of securities fraud litigation."

## **Nasdaq's Disclosure Framework Does Not Govern the Internal Affairs of Corporations**

The Court also dismissed Petitioners' argument that the SEC's approval of Nasdaq's rules regulated corporate governance in a manner that impermissibly interfered with state corporate laws. The Court observed that the SEC's finding that the rules are "a disclosure-based framework, not a quota," was "supported by substantial evidence and therefore conclusive."

The SEC considered that the rules do not compel Nasdaq-listed companies to have diverse board members. A company that does not meet the diversity goal under the rules can simply explain why it does not do so, and Nasdaq will not review the substance of the explanation. If a company without diverse board members fails to meet even this minimal disclosure requirement, it may be delisted—but that "is not a sanction that mandates compliance with the two-diverse-board-members benchmark." Such a company can seek to be listed on another exchange.

The Court quickly disposed of Petitioners' additional arguments that the SEC's approval of the rules violated the "major questions doctrine," and was also arbitrary and capricious.

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