Nasdaq's Board Diversity Rules: Four Rebuttals to the Opposition

Nasdaq's new board diversity rules approved by the SEC back in August drew a significant number of **comments** when initially proposed. The new rules seek to encourage listed companies to diversify their boards by establishing rules for disclosure of their current board diversity (Rule 5606) and setting a diversity objective for boards to meet, with a requirement that if they fail to meet the objective they must disclose that fact and the reason for their failure to comply (Rule 5605(f)). Although most comments submitted to the SEC favored the new Nasdaq rules, some commenters questioned their constitutionality and their legality. Principal objections ranged from concerns about whether the board diversity objective caused boards to violate their fiduciary duty to select the most qualified directors, to whether the rules are constitutional under the equal protection principles of the Fifth Amendment or constitute compelled speech in violation of the First Amendment, to whether they meet many of the criteria under the Exchange Act for SEC approval. One **commenter** has now raised the same constitutional questions in a petition for review of the SEC's order approving the new Nasdaq rules in the U.S. Court of Appeals for the Fifth Circuit, arguing that the new rules will "compel" Nasdaq-listed companies "to illegally discriminate on the basis of gender, race, and sexual orientation in selecting directors." Here is a brief summary of the points made by Nasdaq and the SEC refuting the opponents of the new rules: 1. No breach of director fiduciary duties: The board diversity rules do not impose a quota for board diversity that could cause directors to breach their fiduciary duty by appointing potentially less qualified directors, but set out "aspirational diversity objectives." Together, Rules 5606 and 5605(f) create a disclosure-based framework that would contribute to investors' investment and voting decisions. A company that does not meet the board diversity objective could choose instead to explain why it does not meet the objective, an explanation that will not be second-guessed by Nasdaq. Nasdaq is a voluntary organization and no company is required to list on its exchange. The new rules would benefit shareholders who have expressed strong support for "disclosure requirements that would standardize the reporting of board diversity statistics" by, for one thing, defining the word "diverse." Based in part on shareholder input cited in Nasdaq's February 2021 letter to the SEC accompanying its amended proposals, this information is material to shareholders' investment and voting decisions, but is currently provided, if at all, in an inconsistent and non-comparable manner. 2. Does not violate Fifth Amendment equal protection principles: The board diversity rules "do not constitute state action subject to constitutional scrutiny." The requirement that the SEC approve the new rules does not convert Nasdaq's adoption of the rules into state action. The rules do not mandate a specific number of diverse directors: they establish a disclosure requirement. Companies may choose not to comply with the diversity objective and instead explain their reasons for non-compliance. Even if the board diversity rules did trigger heightened scrutiny under the Fifth Amendment, the rules are necessary to achieve the important government interest of "increasing transparency about board diversity so that investors can make investment decisions based on consistent and readily accessible data". 3. Does not violate the First Amendment: The Rule 5606 requirement to disclose board diversity in a matrix and the Rule 5605(f) requirement to disclose the reasons for noncompliance with the diversity objective do not represent speech improperly compelled by a government actor. Nasdaq is a voluntary association of companies in a contractual relationship. Furthermore, the disclosures required by the board diversity rules are consistent with other disclosure rules adopted by Nasdaq. The rules do not require companies to "convey any specific message." In any event, any burden imposed by the rules would be outweighed by the benefits of encouraging more diverse boards. 4. Meets the Exchange Act requirements for SEC approval: Nasdaq also fielded comments asserting that the new Nasdaq rules failed to meet the criteria for SEC approval set out in Section 6(b)(5) of the Exchange Act, many questioning the link between greater board diversity and better company performance or the protection of investors. Nasdaq acknowledged that some studies disagreed about whether there is a positive correlation between board diversity and company performance. But Nasdaq noted that the Exchange Act does not require that its rules enhance the financial performance of its listed companies, and in any event, the new Nasdaq rules would not have an adverse effect on company performance. Furthermore, studies show that increasing board diversity is correlated with a reduction in fraudulent acts and practices, enhancing investor protection. The new Nasdaq rules would provide greater transparency into the diversity of corporate boards and encourage those boards to become more diverse. The rules would also remove impediments to a free and open market by providing information that is not now readily available or comparable, furthering the purposes of the Exchange Act. Consequently, compliance with the new Nasdaq rules should not conflict with either board fiduciary duties or constitutional principles and the rules should survive the current challenges to their adoption by Nasdaq and approval by the SEC.

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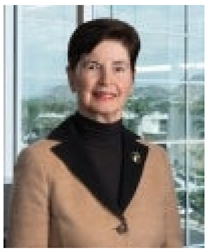

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