

Nasdaq Board Diversity Rules Overturned by US Court of Appeals



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On December 11, 2024, in *Alliance for Fair Board Recruitment v. SEC*, the US Court of Appeals for the Fifth Circuit ruled in a 9-8 vote that the Securities and Exchange Commission's (SEC) adoption of the Nasdaq board diversity rules (which aimed to increase the representation of women and minorities on boards of directors for publicly-traded companies) exceeded the commission's statutory powers. The rules would have required boards of Nasdaq-listed companies to be comprised of at least one female identifying director and one director who identified as an underrepresented minority or LGBTQ+, and provide annual disclosure of the demographic compositions of the board. The SEC originally approved the Nasdaq rules in 2021.

Under proposed Nasdaq Listing Rule 5605(f), companies traded on Nasdaq were required, subject to certain transition periods, to have "at least two members of [their] board of directors who are Diverse, including (i) at least one Diverse director who self-identifies as Female; and (ii) at least one Diverse director who self-identifies as an Underrepresented Minority or LGBTQ+." As an alternative to appointing or electing diverse directors, a company could publicly disclose in its SEC filings why it failed to have the required level of board diversity. Under proposed Nasdaq Listing Rule 5606 (5605(f) and 5606 together, the "Nasdaq Rules"), companies traded on Nasdaq were required to annually disclose information relating to each director's voluntary self-identified characteristics in a standardized matrix. A company that did not comply with the Nasdaq Rules or regain compliance with either rule during their respective applicable cure periods would be subject to delisting.

In October 2024, 22 states attorneys general announced an inquiry in the form of a joint letter to Nasdaq alleging that the Nasdaq Rules may conflict with both state and federal anti-discrimination laws. Similar proposed state laws have also been successfully challenged. In 2018, California enacted a mandatory gender quota for corporate boards, and in 2020, it enacted an additional diversity requirement making it mandatory for public company boards organized in California to include directors from "underrepresented communities". In 2022, the Los Angeles County Superior Court found that the gender diversity requirement violated the equal protection clause of the California constitution and permanently enjoined the rules. In 2023, the US District Court for the Eastern District of California ruled the "underrepresented communities" requirement constitutes an unconstitutional racial quota in violation of the Equal Protection Clause of the Fourteenth Amendment. The state is currently appealing both decisions.

In October 2023, Alliance for Fair Board Recruitment and the National Center for Public Policy Research challenged the Nasdaq Rules before a three-judge panel on the Fifth Circuit. The Court ruled that the constitutional claims failed because Nasdaq is a private entity and not a state actor. The Court also found no violation of the Administrative Procedures Act ("APA"), which governs the process by which federal agencies develop and issue regulations, because the SEC did not exceed the authority designated by the Securities Exchange Act of 1934 in implementing the

Nasdaq Rules. In response to the 2023 decision, plaintiffs requested review by the full Fifth Circuit.

In December 2024, the Court reviewed the APA claims, rejecting the prior ruling. The Fifth Circuit sided with plaintiffs holding that the Exchange Act did not grant the SEC the power to approve board of director diversity requirements. The Court stated that any disclosure requirement must have “some connection to the ills Congress designed the [Exchange] Act to eradicate” (e.g., “speculation, manipulation, and fraud, and removing barriers to exchange competition”). Reviewing under this requirement, the Court did not find any such connection that would “saddle[] companies with an obligation to explain why their boards of directors do not have as much racial, gender, or sexual orientation diversity as Nasdaq would prefer.”

In response to the decision, Nasdaq stated that it stands by the merits of the rule but will respect the Court’s decision without seeking further review. The SEC announced that it is reviewing the decision, but would have to appeal to the US Supreme Court to overturn the Fifth Circuit. Pending an SEC appeal, Nasdaq-listed companies are not presently required to meet the diversity requirements of the Nasdaq Rules. Companies should still consider the impact of board diversity on their stakeholders. Proxy advisory firms such as Institutional Investor Services and Glass Lewis continue to base voting recommendations on board composition and diversity. Large institutional holders such as Blackrock, State Street and Vanguard have all expressed expectations that companies in which they invest promote and attain a certain level of diversity. It remains to be seen whether any such policies will be revised in light of the recent Fifth Circuit ruling. Several states also continue to mandate board diversity or disclosure, including Washington and Maryland, while others, including Maryland, Massachusetts, Colorado and Illinois each have non-binding resolutions encouraging gender diverse boards. As part of its “Women on Corporate Boards Study,” New York has also imposed a gender reporting mandate on public and privately held companies in the state.