

Clients & Friends Memo

SEC Approves Nasdaq's Proposed Rule Changes to Increase Corporate Board Diversity

August 10, 2021

On August 6, 2021, the Securities and Exchange Commission ("SEC") issued [an order](#) approving proposed rule changes submitted by The Nasdaq Stock Market LLC ("Nasdaq") to adopt listing rules related to board diversity. Nasdaq's [proposed rule changes](#), which were filed with the SEC on December 1, 2020, and later [amended](#) on February 26, 2021, would require each Nasdaq-listed company, subject to certain exceptions, to have at least two diverse directors on its board: at least one director who self-identifies as a female and at least one director who self-identifies as an underrepresented racial or ethnic minority or as LGBTQ+. The proposal would also require Nasdaq-listed companies to disclose statistical information on the voluntary, self-identified gender and racial characteristics and LGBTQ+ status of the company's board of directors.

Concurrent with these proposed rule changes, Nasdaq also filed a proposed rule change to provide eligible Nasdaq-listed companies with one year of complimentary access to a board recruiting service, which would provide access to a network of board-ready diverse candidates for companies to identify and evaluate. The SEC also approved this proposed rule change on August 6, 2021.

During the comment period, Nasdaq's proposed rule changes received mixed responses. On the one hand, a significant number of commenters, including Microsoft Corporation, expressed support for Nasdaq's efforts to increase board diversity. In its [comment letter](#), Microsoft observed that Nasdaq's board diversity proposal will "increase investor confidence in the public markets by ensuring listed companies adopt governance structures and follow practices that maximize their chances of long-term stability, predictability, and success." Likewise, The Carlyle Group, a leading global investment firm with \$246 billion in assets under management, submitted a [comment letter](#) in support of Nasdaq's proposals, stating that "diversity is a priority for our business and our investors."

On the other hand, certain commenters, while applauding board diversity as a concept, expressed opposition to mandatory regulation of board composition by an external entity. For example, a group of Senate Republicans on the Senate Banking Committee called on the SEC to reject

Nasdaq's proposals. The [comment letter](#), written by Senator Pat Toomey of Pennsylvania, stated while "[w]e commend individual firms for the proactive efforts they have already made in recruiting, promoting, and maintaining diverse talent . . . it is not the role of Nasdaq . . . to act as an arbiter of social policy or force a prescriptive one-size-fits-all solution upon markets and investors."

In support of its proposed rule changes, Nasdaq acknowledged that gender diversity has improved among U.S. company boards in recent years, but observed that "the pace of change has been gradual, and the U.S. still lags behind other jurisdictions that have imposed requirements related to board diversity." Moreover, "progress toward bringing underrepresented racial and ethnic groups in the boardroom has been even slower." Observing that "diversity in the boardroom is good corporate governance," Nasdaq justified the proposed rule changes on the grounds that "the national market system and the public interest would best be served by an additional regulatory impetus for companies to embrace meaningful and multi-dimensional diversification on their boards."

Board Diversity Requirement

The new Nasdaq Listing Rule 5605(f)(2) will require each Nasdaq-listed company to have, or explain why it does not have, at least two members of its board of directors who are "Diverse," including at least one Diverse director who self-identifies as "Female" and at least one Diverse director who self-identifies as an "Underrepresented Minority" or "LGBTQ+." The Rule defines "Diverse" as "an individual who self-identifies in one or more of the following categories":

- "Female," which is defined as "an individual who self-identifies her gender as a woman, without regard to the individual's designated sex at birth."
- "LGBTQ+," which is defined as "an individual who self-identifies as any of the following: lesbian, gay, bisexual, transgender or a member of the queer community."
- "Underrepresented Minority," which is defined as "an individual who self-identifies as one or more of the following: 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."

The proposal does not preclude companies from considering additional diversity factors, including nationality, disability, or veteran status in selecting board members. However, a company will still have to satisfy its disclosure obligations under Rule 5605(f) if it does not have at least two directors who are Diverse according to the Nasdaq rule's definition.

Exempted Entities

The following entities will be exempt from the requirements of Rule 5605(f):

- acquisition companies;
- asset-backed issuers and other passive issuers (as set forth in Rule 5615(a)(1));
- cooperatives (as set forth in Rule 5615(a)(2));
- limited partnerships (as set forth in Rule 5615(a)(4));
- management investment companies (as set forth in Rule 5615(a)(5));
- issuers of non-voting preferred securities, debt securities, and derivative securities (as set forth in Rule 5615(a)(6)) that do not have equity securities listed on Nasdaq; and
- issuers of securities listed under the Rule 5700 series.

Moreover, Foreign Issuers, Smaller Reporting Companies, and Companies with a Smaller Board, as discussed below, will be subject to different board diversity and disclosure requirements under Rule 5605(f).

Foreign Issuer

Under Rule 5605(f)(2)(B), Nasdaq will require each Foreign Issuer to have, or explain why it does not have, at least two members of its board of directors who are Diverse, which with respect to Foreign Issuers is defined somewhat differently than for U.S. issuers.

A “Foreign Issuer” is defined as either: “(a) a Foreign Private Issuer (as defined in Rule 5005(a)(19)); or (b) a company that (i) is considered a ‘foreign issuer’ under Rule 3b-4(b) under the Act and (ii) has its principal executive offices located outside of the United States.” For Foreign Issuers, the term “Diverse” is defined as “an individual who self-identifies as one or more of the following: Female, LGBTQ+, or an “Underrepresented Individual” based on “national, racial, ethnic, indigenous, cultural, religious, or linguistic identity in the country of the company’s principal executive offices as reported on the company’s Form F-1, 10-K, 20-F, or 40-F.” For a Foreign Issuer that has a two-tiered board system, “board of directors” means the company’s supervisory or non-management board.

Smaller Reporting Company

Under Rule 5605(f)(2)(C), Nasdaq will require a “Smaller Reporting Company,” as set forth in Rule 12b-2 under the Securities Exchange Act of 1965, “to have, or explain why it does not have, at

least two members of its board of directors who are Diverse”—as that term is defined under Nasdaq rule—including at least one Diverse director who self-identifies as Female. The second Diverse director may be an individual who self-identifies as one or more of the following: Female, LGBTQ+, or an Underrepresented Minority.

Company with a Smaller Board

Under Rule 5605(f)(2)(D), Nasdaq will require each company with a board of directors of five or fewer members (“Company with a Smaller Board”) “to have, or explain why it does not have, at least one member of its board of directors who is Diverse.”

Disclosure in Lieu of Satisfying Diversity Objectives

Under Rule 5605(3), a company may elect to satisfy the board diversity requirements under Rule 5605(f)(2) “by disclosing why it does not meet the applicable diversity objectives” under Rule 5605(f)(2). Under this subsection, a company will be required to (i) specify the requirements of Rule 5605(f)(2) that are applicable; and (ii) explain the reasons why it does not have two Diverse directors (or one Diverse director for a Company with a Smaller Board). Furthermore, such disclosure “must be provided in advance of the company’s next annual meeting of shareholders: (a) [i]n any proxy statement or any information statement (or, if a company does not file a proxy, in its Form 10-K or 20-F); or (b) on the company’s website.”

Time Period for Implementation

The new Rule will set forth specific time periods by which each Nasdaq-listed company must satisfy the requirements of Rule 5605(f):

Board Diversity Implementation Deadline	
<i>Currently Listed Companies</i>	
<i>Companies currently listed on Nasdaq</i>	<p>At least one Diverse director by the later of:</p> <ul style="list-style-type: none"> (i) two calendar years after the SEC’s approval of Rule 5605(f) (i.e., by August 6, 2023) (“First Effective Date”); or (ii) the date the company files its proxy statement or information statement for the company’s annual shareholders meeting during the calendar year of the First Effective Date.

	Board Diversity Implementation Deadline
<i>Companies currently listed on the Nasdaq Global Select Market or Nasdaq Global Market</i>	At least two Diverse directors by the later of: <ul style="list-style-type: none"> (i) four calendar years after the SEC's approval of Rule 5605(f) (i.e., August 6, 2025) ("Second NGS/NGM Effective Date"); or (ii) the date the company files its proxy statement or information statement for the company's annual shareholders meeting during Second NGS/NGM Effective Date.
<i>Companies currently listed on the Nasdaq Capital Market</i>	At least two Diverse directors by the later of: <ul style="list-style-type: none"> (i) five calendar years after the approval date of the proposal (i.e., August 6, 2026) ("Second NCM Effective Date"); or (ii) the date the company files its proxy statement or information statement for the company's annual shareholders meeting during the Second NCM Effective Date.
<i>Newly Listed Companies</i>	
<i>Newly listed companies on the Nasdaq Global Select Market or Nasdaq Global Market</i>	At least one Diverse director by the later of: <ul style="list-style-type: none"> (i) one year from the date of listing; or (ii) the date the company files its proxy statement or information statement for the company's first annual meeting of shareholders subsequent to the company's listing; and At least two Diverse directors by the later of: <ul style="list-style-type: none"> (i) two years from the date of listing; or (ii) the date the company files its proxy statement or information statement for the company's second annual meeting of shareholders subsequent to the company's listing.
<i>Newly listed companies on the Nasdaq Capital Market</i>	At least two Diverse directors by the later of: <ul style="list-style-type: none"> (i) Two years from the date of listing; or (ii) The date the company files its proxy statement or information statement for the company's second annual meeting of shareholders subsequent to the company's listing.

	Board Diversity Implementation Deadline
<i>Newly listed Companies with a Smaller Board</i>	At least one Diverse director by the later of: <ul style="list-style-type: none"> (i) two years from the date of listing; or (ii) the date the company files its proxy statement or information statement for the company's second annual meeting of shareholders subsequent to the company's listing.

Board Composition Reporting Requirement

Rule 5606 will require each Nasdaq-listed company, subject to certain exceptions, to publicly disclose on an annual basis its board-level diversity data, consisting of the voluntary self-identified gender and racial characteristics and LGBTQ+ status of the company's board of directors. The disclosed data must be in a substantially similar format as the "Board Diversity Matrix" provided in proposed Rule 5606(a) (also provided below), and must include the following information:

- the total number of directors;
- the number of directors based on gender identity;
- the number of directors based on race and ethnicity, disaggregated by gender identity;
- the number of directors who self-identify as LGBTQ+; and
- the number of directors who did not disclose a demographic background based on gender identity or race and ethnicity.

Each Nasdaq-listed company will be required to be in compliance with the board composition reporting requirements under Rule 5606 by the later of (i) one calendar year from the approval date (i.e., August 6, 2022) ("Effective Date") or (ii) the date the company files its proxy statement or its information statement for its annual meeting of shareholders during the calendar year of the Effective Date.

Example of a Board Diversity Matrix

Board Diversity Matrix [As of [DATE]]				
Board Size:				
Total Number of Directors	#			
Gender:	Male	Female	Non-Binary	Gender undisclosed
Number of directors based on gender identity	#	#	#	#
Number of directors who identify in any of the categories below:	#	#	#	#
African American or Black	#	#	#	#
Alaska Native or American Indian	#	#	#	#
Asian	#	#	#	#
Hispanic or Latinx	#	#	#	#
Native Hawaiian or Pacific Islander	#	#	#	#
White	#	#	#	#
Two or More Races or Ethnicities	#	#	#	#
LGBTQ+	#			
Undisclosed	#			

Board Recruiting Service

In an effort to “assist and encourage listed companies to increase diverse representation on their boards,” which could result in “improved corporate governance, strengthening of market integrity, and improved investor confidence,” Nasdaq proposed to provide certain Nasdaq-listed companies with one year of complimentary access for two users to a board recruiting database, which would provide access to a network of board-ready Diverse candidates for companies to identify and evaluate. This proposal, which was approved by the SEC on August 6, 2021, along with the board diversity and disclosure requirements proposed under Rules 5605(f) and 5606, will offer the recruiting services to any company that represents to Nasdaq that it does not have (i) at least one director who self-identifies as Female, and (ii) at least one director who self identifies as one or more of the following: 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, or who self-identifies as lesbian, gay, bisexual, transgender, or as a member of the queer community.

Takeaway

Nasdaq's board diversity rules are only one recent example of a wider push by certain states, countries outside the United States, regulatory bodies, and market participants to increase board diversity by mandating that the composition of corporate boards reflect certain diversity requirements. Other recent examples include an announcement by Goldman Sachs that starting in 2021 it will help take public only those companies in the United States and Europe that have at least two diverse candidates on the company's board, and a new California law that requires by the end of 2021 all public companies headquartered in California to have at least one director on their boards who is from an underrepresented community.

The wisdom and effectiveness of such rules have been controversial,¹ but the fact remains that progress has been slow, particularly outside of the gender context. Whether or not mandatory, there is by and large a consensus on the importance of a diverse board to the health and profitable functioning of a company.² Therefore, all boards and their nominating and governance committees need to consider seriously the issue of board diversity and be proactive in their efforts to promote and achieve greater diversity at the board level.

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If you have any questions, please feel free to contact any of the following Cadwalader attorneys.

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¹ See Commissioner Allison Herren Lee, *Diversity Matters, Disclosure Works, and the SEC Can Do More: Remarks at the Council of Institutional Investors Fall 2020 Conference* (Sept. 22, 2020), available at <https://www.sec.gov/news/speech/lee-cii-2020-conference-20200922>; FCLTGlobal, *The Long-term Habits of a Highly Effective Corporate Board* (Mar. 2019), available at <https://www.fcltglobal.org/wp-content/uploads/long-term-habits-of-highly-effective-corporate-boards.pdf>. But see Jesse M. Fried, *Will Nasdaq's Diversity Rules Harm Investors?* (Harvard Univ. and ECGI, Working Paper No. 579, 2021), https://papers.ssrn.com/sol3/papers.cfm?abstract_id=3812642.

² See, e.g., David A. Carter et al., *Corporate Governance, Board Diversity, and Firm Value*, 38(1) Fin. Rev. 33; Gennaro Bernile et al., *Board Diversity, Firm Risk, and Corporate Policies* (Mar. 6, 2017), available at <https://ssrn.com/abstract=2733394>.