Blogs
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In a 9-8 decision on December 10, 2024, the U.S. Court of Appeals for the Fifth Circuit struck down Nasdaq's efforts to promote diversity on public company boards. The case, *Alliance for Fair Board Recruitment v. SEC*, vacated the previously adopted Nasdaq board diversity rules, finding that the Securities and Exchange Commission ("SEC") had overstepped its authority under the Securities Exchange Act of 1934, as amended ("Exchange Act"). The ruling comes on an *en banc* rehearing to an earlier Fifth Circuit opinion, which we previously wrote about in "Nasdaq Board Diversity Rules Survive Conservative Groups' Challenge," and reverses the earlier decision.

Nasdaq Diversity Rules. The diversity rules were initially approved by the SEC in August 2021, which we discussed in depth in "5 Things to Know About Nasdaq's Board Diversity Disclosure Requirement." They 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 generally required to have a minimum of two diverse directors (as defined in the rules)—including one self-identified female director and one self-identified underrepresented minority (as defined in the rules) or LGBTQ+ director—or to explain why they did not meet these requirements. We refer to these requirements as the "Board Diversity Rules" or the "Rules."

Fifth Circuit Decision. The court held that the SEC's approval of the Nasdaq Board Diversity Rules was "arbitrary and capricious" because the SEC failed to justify its determination that the Rules were consistent with the requirements of the Exchange Act. In vacating the SEC's order approving the Board Diversity Rules, the court focused on several key points outlined below.

The Nasdaq Board Diversity Rules Were Not Related to the Purposes of the Exchange Act

Key to the court's ruling was a determination that the SEC lacked the power to approve the Board Diversity Rules, finding that the Rules did not relate to the purposes of the Exchange Act. The court first addressed the SEC's statutory role in approving regulations proposed by self-regulatory organizations ("SROs"). The SEC *must* approve an SRO's proposal but only if "it finds [the proposal] is consistent with the requirements of the Exchange Act." The court further noted that under a 1975 amendment to the Exchange Act, the SEC must find that a proposed rule is limited to matters "related to the purposes of [the Exchange Act]."

The court analyzed the history of the Exchange Act, concluding that Congress had adopted the Exchange Act "primarily to protect investors and the American economy from speculative, manipulative, and fraudulent practices." The SEC and Nasdaq argued that the Rules were merely disclosure requirements and that full disclosure is a core purpose of the Exchange Act. The court disagreed that "full disclosure" is an adequate basis for the adoption of the Rules under the Exchange Act. Instead, the court stated that full disclosure is a proper purpose "only if it is related to the elimination of fraud, speculation, or some other Exchange Act-related harm."

In approving the Board Diversity Rules, the SEC had considered evidence that the "information about the racial, gender, and sexual characteristics of the directors of public companies was 'important to' large institutional investors and investment managers" and found that the Rules "would make board diversity information available to these and other investors on a consistent and comparable basis." Thus, in the SEC's view, the Rules were "designed to promote just and equitable principles of trade, remove impediments to and perfect the mechanism of a free and open market and a national market system, and protect investors and the public interest," consistent with the requirements of the Exchange Act.

The court disagreed, finding that the Rules (i) did not "promote just and equitable principles of trade" because they are not directed toward the unethical practices this Exchange Act language addresses, (ii) did not "remove impediments to" or "perfect the mechanism of a free and open market" because they are not related to a free and open market in the execution of securities transactions as the Exchange Act intends, and (iii) were not "designed . . . in general, to protect investors and the public interest" within the meaning of the Exchange Act because they were not related to the more specific purposes enumerated in the Exchange Act. In sum, the court found that "the purposes [of the Exchange Act] bear no relationship to the disclosure of information about the racial, gender, and sexual characteristics of the directors of public companies."

The Major Questions Doctrine

The major questions doctrine holds that "administrative agencies have no independent constitutional provenance" but "possess only the authority that Congress has provided." Accordingly, their "powers to make major decisions must come only from unequivocal statutory text." The court found that the SEC's approval of the Board Diversity Rules presented a "major question" because the SEC's decision has great economic significance due to Nasdaq's position as "the second-largest exchange in the world" and great political significance because issues of diversity and inclusion are "politically divisive." Furthermore, the court found that approval by the SEC was both a "novel" exercise of its power and an intrusion on well-established state authority to regulate the powers of corporations. Thus, the SEC was required to rely on clear statutory language for its authority to approve the Rules. Instead, the court stated that the SEC "has intruded into territory far outside its ordinary domain."

Additional SEC and Nasdaq Arguments

In addition to defending the Board Diversity Rules as disclosure rules, the SEC and Nasdaq argued that, as a private institution, Nasdaq should have the power to formulate rules relating to governing listed companies and that exchanges have adopted many similar corporate governance rules. The court disagreed, pointing to the fact that Congress had limited the regulatory power of exchanges to matters that are related to the Exchange Act.

Constitutional Challenges

The Nasdaq Board Diversity Rules had been challenged, in part, on grounds that the Rules violated the First and Fourteenth Amendments to the U.S. Constitution. The court stated that it did not need to consider the constitutional challenges to the Rules since the case was being resolved on statutory grounds.

The Dissent

Eight judges joined a dissenting opinion. The dissent noted that the majority opinion sought to supplant private ordering by an SRO with its own assessment of whether a proposed rule connects to the purposes of the Exchange Act. The dissent noted the SEC "approved the Rule because the reviewing scheme that Congress created doesn't permit the SEC to displace Nasdaq's private business judgment—informed by investor behavior—with agency policy priorities." The dissent gave credence to the volume of evidence considered by the SEC that board diversity information "was highly sought after but inefficient to acquire, especially accurately." The dissent also faulted the majority for finding that the purposes of the Exchange Act "do *not* include the elimination of information asymmetries regarding corporate board leadership—the very leaders entrusted with investors' money and whose identity investors across the full spectrum of the economy seek." The dissent concluded that the Rules "would provide widely available, consistent, and comparable information that would contribute to investors' investment and voting decisions"; therefore, the SEC's approval of the Rules was not arbitrary and capricious.

Next Steps. The SEC has noted that it is reviewing the decision. Nasdaq has stated that it does not intend to appeal the ruling. While the diversity disclosure requirements and minimum diverse director requirements no longer apply for Nasdaq-listed companies, companies should consider the guidelines of proxy advisory firms and institutional investors. Companies may determine, based on their investor base, to continue to disclose certain information about board diversity and/or seek diverse board composition.

Authors

Evelyn Cruz Sroufe

Of Counsel
ESroufe@perkinscoie.com 206.359.8502

Christopher Wassman

Counsel
CWassman@perkinscoie.com 206.359.3807

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