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Fifth Circuit Overturns Nasdaq's 'Show or Tell' Diversity Policy

Go-To Guide

- Fifth Circuit strikes down Nasdaq's board diversity disclosure rule.
- Nasdaq communicates its acceptance of the court's decision to listed companies.
- Listed companies no longer need to comply with the rule.

On Dec. 11, 2024, the Fifth Circuit, in a divided opinion following an *en banc* hearing, struck down Nasdaq's so-called "show or tell" board diversity disclosure rule – Corporate Governance Rule 5605(f) (the Rule). The court found that the Rule, which the majority characterized as a "public-shaming penalty for a corporation's failure to abide by the Government's diversity requirements," exceeded SEC Exchange Act rulemaking authority. The Rule has drawn criticism, including from some strong supporters of diversity goals, for its formulaic and categorical approach to boardroom diversity disclosure.

Nasdaq-listed companies began receiving letters from the exchange during the week of Dec. 8, stating that Nasdaq does not intend to seek further review of the decision. As a result, companies will no longer be required to comply with the Rule, although Nasdaq may undertake future rulemaking attempts. But given the imminent change in administration, any such action in the near future appears unlikely.

Companies should nevertheless evaluate their shareholders, employees, customers, and other constituencies' expectations and consider tailoring their diversity program disclosures accordingly.

The Legal Challenge to Nasdaq's Diversity Disclosure Rules

In *Alliance for Fair Board Recruitment v. SEC*, the Fifth Circuit struck down Nasdaq Rule 5605(f) requiring listed companies to disclose their boards' gender, sexual orientation, and racial makeup, or to explain why the companies were unable to achieve the mandated diversity metrics.

The majority of a divided *en banc* court rejected Nasdaq's board diversity rules as exceeding the purposes of the Exchange Act. Following an extensive historical analysis of the 1934 Exchange Act and its 1975 Amendments, the court's majority concluded that nothing in the Exchange Act required disclosure "for disclosure's sake," noting the act's purpose was to prevent market abuses.

The court also rejected the SEC's argument that the diversity disclosure rule was designed to remove impediments to a "free and open market" because fostering a free and open market entailed enacting measures to reduce transaction costs associated with executing securities trades. "Equipping investors to make investment and voting decisions might be a good idea, but it has nothing to do with the execution of securities transactions."

The court also rejected the SEC's argument that the Rule was designed to protect investors and the public interest. It found that this "catch-all" provision of the Exchange Act was intended to address "speculation, manipulation, fraud, and anticompetitive exchange behavior." To that end, diversity did not implicate the public interest because the SEC failed to establish a "link between the racial, gender and LGTBQ+ identities of a company's board members and 'the quality of a company's financial reporting, internal controls, public disclosures and management oversight.'"

The court also found that the SEC had provided no empirical support for its claimed relationship between board diversity and corporate governance quality. The court reasoned that, even if board diversity information was important to investors, nothing in the Exchange Act granted this type of rulemaking authority under a broad public interest provision.

The court also invoked the "major questions" doctrine as further grounds for determining that the SEC had outreached its authority. The court noted that diversity was among one of the more politically divisive issues in the nation and that there was no evidence that Congress had intended the SEC to wade into these waters. Further, the court found that during the Exchange Act's introduction in 1934, the SEC never claimed the authority to impose anything resembling boardroom diversity requirements. By doing so now, the SEC had intruded into state-law domain.

Potential *Alliance* Decision Impact

The *Alliance* case is one of several recent decisions that have used the "major decisions" doctrine to trim the sails of regulatory agencies acting outside the recognized core of their remit. Viewed in that light, the case may be seen narrowly as a technical administrative law interpretation.

A broader reading of *Alliance* suggests it further evidences a limitation on governmental efforts to use regulatory rulemaking authority to foster progressive social goals.

While the *Alliance* terminates the current Nasdaq disclosure rule, companies should be aware of the continuing interest in (and support for or opposition to) diverse board representation among their constituencies and consider shaping their responses accordingly.

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