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NASDAQ BOARD DIVERSITY RULES THROWN OUT BY FIFTH CIRCUIT

On December 11, 2024, the U.S. Court of Appeals for the Fifth Circuit rendered a closely divided 9-8 *en banc* decision, striking down Nasdaq's board diversity rules. The court determined that the SEC exceeded its statutory authority under the Exchange Act by approving these rules. As a result, Nasdaq-listed companies are no longer required to comply with the board diversity rule requirements.

The majority opinion characterized the rules as a "public-shaming penalty" for non-compliance with government-imposed diversity mandates. The court underscored that the primary objective of the Exchange Act is to prevent market abuses, not to mandate disclosures solely for their own sake. Furthermore, the ruling pointed out that the SEC failed to establish a link between board diversity and the quality of a company's financial reporting, internal controls, public disclosures, and management oversight.

The newly-vacated Board Diversity rules, which were the only existing federal-level board diversity rules, had mandated all operating companies listed on Nasdaq's U.S. Exchange to (1) publicly disclose board-level diversity statistics using a Board Diversity Matrix template; and (2) either comply with the Board Diversity Rule's diversity requirements or provide an explanation in the event of noncompliance. Companies were required to disclose (i) the total number of directors and (ii) how those directors self-identify regarding gender, predefined race and ethnicity categories, and LGBTQ+ status. Companies were also required to have diverse members on their board of directors or provide an explanation for why they did not. The specific diversity requirements for the board of directors varied based on company size.

In its petition for review, Alliance for Fair Board Recruitment contended that Nasdaq's rule constituted impermissible state action in violation of the Fifth and Fourteenth Amendments, and that the SEC's approval violated the agency's statutory obligations under the Securities Exchange Act and the Administrative

Procedure Act. The Fifth Circuit panel initially rejected these arguments, finding first that Nasdaq is not bound by constitutional restrictions because it is a private entity rather than a state actor, and further that the SEC acted within its authority in approving the rule.

However, the court applied the "major questions" doctrine in holding that the SEC lacked statutory authority to approve the rule due to an absence of clear congressional authorization. The SEC and Nasdaq argued, among other things, that the SEC has broad authority to implement board diversity requirement given that disclosure is a "core" purpose of the Exchange Act. The Court rejected that argument, finding that a disclosure rule is related to the Exchange Act only if it relates to "the elimination of fraud, speculation, or some other Exchange Act–related harm."

Nasdaq has notified listed companies that it does not intend to seek further review. Although the SEC has stated that it is still reviewing the ruling, Nasdaq's announcement, along with the Fifth Circuit's ruling and the incoming changes to leadership at the SEC under the new Administration, means companies will no longer have to comply with Nasdaq's Board Diversity rule requirements.

Clifford Chance is continuing to monitor further developments. In the meantime, companies should carefully assess the potential implications for their board composition and disclosure practices, including where state laws continue to apply.

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