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Memorandum

In Latest DEI-Related Litigation Development, Fifth Circuit Declines to Review SEC's Approval of Nasdaq's Board Diversity Rule

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On October 18, 2023, a three-judge panel for the U.S. Court of Appeals for the Fifth Circuit denied petitions to review the SEC's approval of Nasdaq's board diversity disclosure rule, which requires Nasdaq-listed companies to have female and minority or LGBTQ+ directors on their boards (or explain why they do not), and disclose diversity statistics of their directors.[1] With this decision, the Nasdaq rule remains in effect, and Nasdaq-listed companies subject to the rule should be prepared to comply with the initial annual reporting deadline of December 31, 2023. In declining to review the SEC's approval of the rule, the disclosure-based framework for the rule may help guide corporate approaches to other diversity, equity and inclusion ("DEI") policies, programs and practices.

Background

On August 6, 2021, the SEC approved Nasdaq's proposed board diversity disclosure rule, requiring Nasdaq-listed companies to: (i) have at least one director who identifies as female and at least one director who identifies as an "underrepresented minority" or LGBTQ+ (together, "Diverse") (or, if the company has five or fewer directors, one Diverse director) on their board, or explain why they do not; and (ii) disclose annually, using a standardized template, the gender identity and demographic background of their board members, subject to certain exceptions.[2] In the December 14, 2022 amendments to the rule, the SEC amended the initial compliance deadline to December 31, 2023.[3] The SEC stated in its approval that the rule "would establish a disclosure-based framework and not a mandate or quota" and would not "mandate any particular board composition."[4] Indeed, companies without the requisite number of diverse directors could still comply with the rule by explaining why the

[1] Order, *Alliance for Fair Board Recruitment et. al. v. SEC*, No. 21-60626 (5th Cir. Oct. 18, 2023).

[2] Securities And Exchange Commission, Release No. 34-92590, File Nos. SR-NASDAQ-2020-081, SR-NASDAQ-2020-082 (Aug. 6, 2021), available here; *see also* Securities And Exchange Commission, Release No. 34-96500, File No. SR-NASDAQ-2022-075 (Dec. 14, 2022), available here (proposed rule change).

[3] Securities And Exchange Commission, Release No. 34-96500, File No. SR-NASDAQ-2022-075 (Dec. 14, 2022), available here; *see also* Nasdaq, Nasdaq's Board Diversity Rule: What Companies Should Know (Feb. 28, 2023), available here (explaining reporting deadlines by company listing date).

[4] Securities And Exchange Commission, Release No. 34-92590, File Nos. SR-NASDAQ-2020-081, SR-NASDAQ-2020-082 (Aug. 6, 2021), at 15-16, available here.

company did not meet the objectives, and the SEC noted that "the Exchange would not assess the substance of the company's explanation."[5]

On August 10, 2021 and October 5, 2021, the Alliance for Fair Board Recruitment ("AFBR") and the National Center for Public Policy Research ("NCPPR"), respectively, filed petitions for review of the SEC order approving the rule. The petitions argued that: (i) Nasdaq's rule, which the SEC approved, is unconstitutional under the Fifth Amendment's Equal Protection Clause and the First Amendment's Freedom of Expression clause; and (ii) the SEC, in approving the rule, exceeded its authority and violated its statutory obligations under the Securities Exchange Act of 1934 and the Administrative Procedure Act. The Fifth Circuit rejected these arguments, finding that (i) Nasdaq is not a state actor and the rule is not a state action subject to such constitutional challenges, and (ii) the SEC did not exceed its authority in approving the rule.

Fifth Circuit Rejects Constitutional and Statutory Challenges

The Appeals Court rejected petitioners' constitutional and statutory claims, framing Nasdaq's diversity rule as consistent with the Securities Exchange Act's "fundamental purpose" of enforcing "a philosophy of full disclosure . . . in the securities industry."[6]

CONSTITUTIONAL CLAIMS

The Court rejected petitioners' constitutional challenges, because the Constitution applies only to state action, and (i) Nasdaq is a private entity and not a state actor, and (ii) the Nasdaq rule cannot be attributed to the SEC.

With respect to the petitioners' first theory, the Court found that Nasdaq is a private entity, and while it must register with the SEC, "a private entity does not become a state actor merely by virtue of being regulated."[7] Perhaps paving the path for a denial of a future petition for *en banc* review, the Court distinguished its holding as not "depart[ing]" from dicta in another Fifth Circuit case, in which the court had said "[t]he intimate involvement of the [American Stock] Exchange with the [SEC] brings it within the purview of the Fifth Amendment controls over due process."[8]

As for petitioners' second theory, the Court found that the rule was not "fairly attributable" to the government because there was not a "sufficiently close nexus" between the government and the challenged action.[9] Specifically, under a three-pronged test, the Court found that: (i) exchange listing standards are not a "traditional, exclusive public function"; (ii) comments of two commissioners in favor of diversity disclosure policies in the context of a separate SEC rule did not compel Nasdaq to take a particular action; and (iii) the SEC was not "pervasively entwined" with Nasdaq such that they acted jointly in rulemaking because Nasdaq generated the rule

[5] *Id.*

[6] *Alliance* at 1 (quoting *Affiliated Ute Citizens of Utah v. United States*, 406 U.S. 128, 151 (1972) (citations omitted)).

[7] *Id.* at 8.

[8] *Id.* at 11-13 (citing *Intercontinental Industries, Inc. v. American Stock Exchange*, 452 F.2d 935, 941 (5th Cir. 1971)).

[9] *Id.* at 17.

and submitted it to the SEC, and a "yes-or-no approval process does not reflect" the requisite degree of entwinement.[10]

Finally, the Court declined to address whether the rule was "state action" due to the SEC's ability to sanction Nasdaq for non-enforcement of the rule because petitioners did not challenge any rule enforcement action or the SEC's authority to sanction.[11]

STATUTORY CLAIMS

The Court also rejected petitioners' arguments that the SEC's approval order exceeded its authority under the Exchange Act, and that the SEC had acted arbitrarily or capriciously in violation of the Administrative Procedure Act.

First, the Court found that the Exchange Act's requirement that the SEC ensure exchange rules are "designed" to meet certain statutory objectives, did not limit the SEC to considering only "objective evidence" in deciding to approve a proposed rule. Instead, the SEC properly relied on subjective opinions of investors because they were relevant to the issue at hand.[12]

Second, the Court rejected petitioner's contention that the SEC's authority to approve disclosure rules under the Exchange Act is limited to rules disclosing "material" information, or information that has "a substantial likelihood that a reasonable investor would consider the information important in making a decision to invest."[13] Instead, the Court acknowledged the "fundamental purpose" of the Exchange Act is "implementing a philosophy of full disclosure," and highlighted that the Exchange Act gives broad discretion to the SEC to promulgate disclosure rules.[14] But even if materiality were the standard, "substantial evidence supports the SEC's finding that Nasdaq's rule would provide 'information that would contribute to investors' investment and voting decisions" because investors already use board diversity information to make investments.[15]

Third, the SEC's approval of the rule was not an improper infringement of state authority to regulate corporate governance because the proposal is a disclosure rule, which the SEC is authorized to approve under the Exchange Act, and not a mandatory quota.[16]

Fourth, the Court rejected petitioners' invocation of the "major questions doctrine," which applies to "extraordinary cases" where courts are "reluctant to read into ambiguous statutory text a delegation of authority

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[10] *Id.* at 17-19.

[11] *Id.* at 21.

[12] *Alliance* at 24-26.

[13] *Id.* at 26.

[14] Securities And Exchange Commission, Release No. 34-96500, File No. SR-NASDAQ-2022-075 (Dec. 14, 2022), available here; *see also* Nasdaq, Nasdaq's Board Diversity Rule: What Companies Should Know (Feb. 28, 2023), available here (explaining reporting deadlines by company listing date).

[15] *Id.* at 28-30.

[16] *Id.* at 31.

to the agency," and "the agency must point to a clear congressional authorization for the power it claims."[17] The Court found that the case was not a "major questions case," because "[d]isclosure rules, including those related to diversity, are business as usual for the SEC, and there is nothing unheralded or unprecedented about the SEC's Approval Order here."[18]

Finally, with respect to the Administrative Procedure Act, the court held that the SEC had not acted arbitrarily or capriciously in approving the rule. The administrative record provided substantial evidence to support the SEC's findings, including that "[b]oard-level diversity statistics are currently not widely available on a consistent and comparable basis, even though [Nasdaq] and many commenters argue that this type of information is important to investors."[19]

Implications

The Fifth Circuit's decision is another example of the recent increase in courts addressing lawsuits challenging DEI policies, programs and practices. Despite mounting an unsuccessful challenge to the Nasdaq board diversity disclosure rule, petitioners and similarly aligned litigants will likely continue to assert novel legal arguments to challenge DEI initiatives in the private sector. Indeed, the petitioners in this case have previously mounted DEI-related legal challenges, successfully and unsuccessfully. Petitioner AFBR is led by Edward Blum, who also brought the *Students for Fair Admissions* litigation, where the Supreme Court held that Harvard University's and the University of North Carolina's admissions programs violated the Equal Protection Clause of the Fourteenth Amendment.[20] Petitioner National Center for Public Policy Research filed a complaint against Starbucks and its directors and officers, alleging that the company's DEI policies were discriminatory. The Eastern District of Washington dismissed the lawsuit, reaffirming the boards' deliberative process in making business decisions that are in the best interests of the company.[21]

While petitioners could yet seek *en banc* review of the decision or further review at the Supreme Court,[22] the Fifth Circuit's decision not to review the Nasdaq diversity disclosure rule may give boards and companies greater confidence in developing and disclosing corporate diversity policies, outside of the context of board composition, in a manner that will withstand judicial scrutiny.

[17] *Id.* at 35-26 (internal citations and quotations omitted).

[18] *Id.* at 37 (internal citations and quotations omitted).

[19] *See id.* at 41-52.

[20] *See Students for Fair Admissions, Inc. v. President & Fellows of Harv. Coll.*, 143 S. Ct. 2141, 2175 (2023).

[21] *See National Center for Public Policy Research v. Schultz et al.*, No. 22-cv-00267 (E.D. Wash. Sept. 11, 2023).

[22] *See* Julian Mark, *Nasdaq diversity rules survive challenge in federal appellate court,* WASHINGTON POST (Oct. 21, 2023), available here.

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