

# Memorandum

## Fifth Circuit Vacates SEC's Approval of Nasdaq Board Diversity Rules

December 13, 2024

On December 11, 2024, the U.S. Court of Appeals for the Fifth Circuit issued a 9-8 decision vacating the SEC's approval of Nasdaq's Disclosure Rule<sup>1</sup> and Diversity Rule<sup>2</sup> (the "Rules"), holding that the SEC exceeded its authority under the Securities Exchange Act of 1934 ("Exchange Act").<sup>3</sup> Nasdaq has reportedly indicated that it does not intend to appeal the ruling, while an SEC spokesperson has stated the agency is "reviewing the decision and will determine next steps as appropriate."<sup>4</sup>

Given post-election leadership changes, including at the SEC, it is unlikely that the decision will be challenged, and, as a result, Nasdaq-listed companies will no longer be required by Nasdaq to meet diversity targets with respect to their boards or disclose why they do not do so. It is anticipated that many of these companies will take immediate steps in response to this development, including to remove the mandated tabular disclosure on this topic from their 2025 annual meeting proxy statements.

Nasdaq's Rules were originally approved by the SEC in 2021:

- Rule 5606 (the Disclosure Rule) required companies to publicly disclose board-level diversity statistics annually using a standardized template, related to the number of directors and those directors' self-identified gender, race and ethnicity, and LGBTQ+ status.
- Rule 5605(f) (the Diversity Rule) required companies to have, or explain why they did not have, a certain number of diverse board members.

The majority opinion in the Fifth Circuit decision stated that the SEC's approval of Nasdaq's Rules violated the Exchange Act on the basis that the SEC did not adequately explain how the Rules were connected to the purposes of the Exchange Act, which are (among others) "to protect investors and the macroeconomy from speculative, manipulative and fraudulent practices and to promote competition in the market for securities transactions." According to the majority opinion, disclosure regarding racial and sexual diversity is not sufficiently related to the

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<sup>1</sup> Nasdaq Rule 5606.

<sup>2</sup> Nasdaq Rule 5605(f).

<sup>3</sup> *Alliance for Fair Board Recruitment v. SEC*, 21-60626 (5th Cir. Dec. 11, 2024).

<sup>4</sup> Andrew Ramonas, *Nasdaq Board Diversity Rules Struck Down by Fifth Circuit (2)*, BLOOMBERG L. (Dec. 11, 2024), <https://news.bloomberglaw.com/esg/nasdaq-board-diversity-regulations-struck-down-by-fifth-circuit>.

purpose of investor protection. The Court also indicated that disclosure on the lack of racial and sexual diversity, as required by the comply or explain nature of the Diversity Rule, is similarly irrelevant to the purpose of the Exchange Act.

Further, the Court applied the “major questions doctrine” to the SEC’s actions, stating that the Rules “attempt to transform the internal structure of many of the largest corporations in the world” and concern politically divisive issues, making the SEC’s regulation of the Rules economically and politically significant. Under the major questions doctrine, the SEC only has as much authority as Congress has given it in “unequivocal statutory text.” Given that the SEC is “stepping outside its ordinary regulatory domain of market manipulation and proxy voting and intruding into the province of other agencies,” the Court said its actions in approving Nasdaq’s Rules oversteps its clear congressional authorization.

The Fifth Circuit’s decision follows a May 2023 decision by the Eastern District of California to strike down California Assembly Bill 979 (“AB 979”), which would have required domestic or foreign public companies with their principal executive office in California to ensure minimum representation from “underrepresented communities” on their boards. In that case, the court held that AB 979 established a “race-based quota” in violation of the Equal Protection Clause of the Fourteenth Amendment and 42 U.S.C. § 1981. Similar arguments has been raised earlier in the Nasdaq litigation; however, a prior Fifth Circuit panel held that the Fourteenth (and First) Amendments were inapplicable to Nasdaq, as Nasdaq is a private entity and its Rules were not attributable to the government.<sup>5</sup>

The Court’s action vacating the Nasdaq Rules comes at a time of increased attention on and heightened legal risk with respect to diversity, equity and inclusion (“DEI”) programs, in particular workplace-related initiatives. However, many of the largest U.S. institutional investors continue to support board diversity policies that motivate companies to disclose certain information about the makeup of their boards and/or meet target diversity thresholds. Indeed, one of the SEC’s arguments for approving the Nasdaq Rules in the first place was to establish a disclosure-based framework to make such information available on a consistent and comparable basis. With this Fifth Circuit ruling, however, the last remaining U.S.-based board diversity rule has been struck down.

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<sup>5</sup> *Alliance for Fair Board Recruitment v. SEC*, 21-60626 (5th Cir. Oct. 18, 2023).

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