August 26, 2021

SEC Approves Nasdaq Board Diversity Rules

Attorneys
Paul M. Kinsella
Emily J. Oldshue
Jeremiah Williams
Jimena Acuña Smith

The Securities and Exchange Commission (SEC) recently approved the Nasdaq Stock Market LLC's (Nasdaq) board diversity rules (Rules 5605(f) and 5606). The new rules require Nasdaq-listed companies to disclose annually demographic board composition information in a prescribed tabular format, and, if a company lacks at least two diverse directors, one self-identified as female and one self-identified as a member of an underrepresented minority and/or LGBTQ+, then the company must disclose publicly the reason for its lack of board diversity.

The rule considers a director diverse if the individual self-identifies as (1) female and/or (2) a member of an underrepresented minority and/or (3) LGBTQ+. An individual who identifies as Black or African American, Hispanic or Latinx, Asian, Native American or Alaska Native, Native Hawaiian or Pacific Islander or as two or more races or ethnicities that includes one of the foregoing is considered an underrepresented minority. LGBTQ+ means an individual who self-identifies as lesbian, gay, bisexual, transgender or a member of the queer community.

BOARD DIVERSITY MATRIX

A board diversity matrix must be disclosed annually in a company's annual meeting proxy statement or information statement (or Form 10-K or Form 20-F if the company does not file a proxy statement or information statement) beginning with filings for calendar year 2022.[1] In lieu of including the matrix in such an SEC filing, a company may publish the board diversity matrix on its website on the date the company files its proxy statement or information statement and submit to Nasdaq a link to the disclosure. In subsequent annual disclosures, the diversity information included in the matrix must cover two years.

SATISFACTION OF BOARD DIVERSITY OBJECTIVE

Under the new rule, the two-diverse-directors objective will phase in as follows:

- Companies listed on the Nasdaq Global Select Market or the Nasdaq Global Market are required to have, or explain why they do not have, one diverse director by August 7, 2023, and two diverse directors by August 6, 2025.

- Companies listed on the Nasdaq Capital Market are required to have, or explain why they do not have, one diverse director by August 7, 2023, and two diverse directors by August 6, 2026.

- Companies with boards that have five or fewer directors, regardless of listing tier, are required to have, or explain why they do not have, one diverse director by August 7, 2023.

If a company files its proxy statement or its information statement (or Form 10-K or Form 20-F if the company does not file a proxy statement or information statement) for the company's annual shareholders meeting after August 6 in a referenced calendar year, then the company has until the date it makes such filing to meet, or explain why it does not meet, the applicable diversity objective.

[1] If a company files its 2022 proxy statement or information statement (or its Form 10-K or Form 20-F) before August 8, 2022 and does not include the matrix, the company will have until August 8, 2022 to disclose the matrix. Such disclosure can be made on the company's website or in an amended annual report on Form 10-K or Form 20-F.

If a company does not meet the applicable diversity objective, it must publicly explain, in the same document or website location in which it discloses or publishes its board diversity matrix, why it does not meet the applicable objective. Nasdaq will not evaluate the merits of explanations.[2] If a company fails to publicly explain the deficiency, the company will be subject to delisting if it does not cure the deficiency by meeting the applicable diversity objective or by publicly explaining the reasons it does not meet the objective by the later of its next annual meeting and 180 days from the event that caused the deficiency.

EXCEPTIONS

The requirements described above are subject to the following exceptions and relief:

- **New Listings**
  - A company newly listing on the Nasdaq Global Select Market or the Nasdaq Global Market must have, or explain why it does not have, (a) at least one diverse director by the later of (i) one year from the listing date and (ii) the date the company files its proxy statement or information statement (or Form 10-K or Form 20-F if the company does not file a proxy statement or information statement) for the company's first annual shareholders meeting after its listing; and (b) at least two diverse directors by the later of (i) two years from the listing date and (ii) the date the company files its proxy statement or information statement (or Form 10-K or Form 20-F if the company does not file a proxy statement or information statement) for the company's second annual shareholders meeting after its listing.
  - A company newly listing on the Nasdaq Capital Market must have, or explain why it does not have, at least two diverse directors by the later of (a) two years from the listing date and (b) the date the company files its proxy statement or information statement (or Form 10-K or Form 20-F if the company does not file a proxy statement or information statement) for the company's second annual shareholders meeting after its listing.
  - A company newly listing on the Nasdaq Global Select Market, the Nasdaq Global Market or the Nasdaq Capital Market with a board comprising five or fewer directors must have, or explain why it does not have, at least one diverse director by the later of (a) two years from the listing date and (b) the date the company files its proxy statement or information statement (or Form 10-K or Form 20-F if the company does not file a proxy statement or information statement) for the company's second annual shareholders meeting after its listing.
- **Smaller Reporting Companies, Foreign Issuers and Smaller Boards**
  - Smaller reporting companies and foreign issuers may meet the diversity requirements with two female directors. Additionally, foreign issuers may include "underrepresented individuals" in lieu of "underrepresented minorities" to satisfy the diversity objective, defined as a person who self-identifies as an underrepresented individual based on national, racial, ethnic, indigenous, cultural, religious or linguistic identity in the country where the foreign issuer's principal executive offices are located. Companies with five or fewer directors can meet the diversity objective by having at least one diverse

[2] Nasdaq's Chief Legal & Chief Regulatory Officer indicated that companies "can choose to disclose as much, or as little, insight into the company's circumstances or diversity philosophy as the company determines, and shareholders may request additional information directly from the company if they need additional information to make an informed voting or investment decision." For example, a company could state simply, "The company does not meet the diversity objectives of Rule 5605(f)(2)(C) because it does not believe Nasdaq's listing rule is appropriate."

director, whether someone who identifies as female and/or a member of an underrepresented minority and/or LGBTQ+.

- **Non-Operating Entities**
  - Certain special purpose acquisition companies, asset-backed issuers and other passive investors, cooperatives, limited partnerships, management investment companies, issuers of non-voting preferred securities, debt securities and derivative securities that do not have equity securities listed on Nasdaq and issuers of securities listed under Nasdaq's Rule 5700 series are exempt from the board diversity rules. (Note that while closed end funds are exempt from the rule, business development companies are not (Rule IM-5615-4).)

- **Grace Periods**
  - If a company ceases to be exempt from the board diversity rules or no longer qualifies as a smaller reporting company or foreign issuer, it must comply with the rules as of the later of (a) one year from the date that the company no longer qualifies and (b) the date the company files its proxy statement or information statement (or Form 10-K or Form 20-F if the company does not file a proxy statement or information statement) for the company's first annual meeting subsequent to losing its prior status.
  - If a company no longer meets the diversity objectives as a result of a board vacancy (such as due to a director's illness, resignation, or death), it has until the later of (a) one year from the date of the vacancy and (b) the date the company files its proxy statement or information statement (or Form 10-K or Form 20-F if the company does not file a proxy statement or information statement) in the calendar year following the date of the vacancy to meet, or explain why it does not meet, the applicable diversity objectives.

LEGAL CHALLENGE

Earlier this month, a nonprofit organization challenged the new rules by filing a petition for review in the U.S. Court of Appeals for the Fifth Circuit. This organization also brought one of several suits against a California law requiring diversity on the boards of publicly held companies with principal executive offices in the state. No substantive briefing has occurred in the challenge to the new rules, but the petitioner previewed three main legal arguments in its comments filed with the SEC as part of the rulemaking process:

- **Statutory Scope –** Petitioner contends that Nasdaq did not meet its burden of showing that the new rules further a legitimate statutory purpose. In its order adopting the new rules, the SEC discussed studies of whether board diversity benefits companies and ultimately concluded that the evidence is mixed. However, the SEC noted that these studies tended to involve board diversity mandates and are inapplicable to the new rules, which do not have a mandate and only require disclosure. Given the broad range of existing rules promulgated under the Securities Exchange Act of 1934 that require company disclosures, it seems somewhat unlikely that the new rules would be invalidated on this basis alone.

- **Equal Protection –** Petitioner argues that the new rules constitute discrimination based on sex, race and sexual orientation, and do not meet the constitutional strict scrutiny standard. Nasdaq takes the position that it is not a state actor and, therefore, is not subject to this constitutional test. It also contends that the new rules satisfy strict scrutiny because they do not mandate any particular number of diverse directors and serve a compelling state interest. Nasdaq relies heavily on the fact that the new rules only require disclosure, a feature that petitioner views as a First Amendment problem.

- **Speech –** Petitioner claims that the new rules compel speech in violation of the First Amendment. Companies that do not meet the board diversity objective must explain why. Petitioner argues that the explanation is forced speech even though the new rules do not have any specific requirements about what is in this explanation. Nasdaq maintains that it is not bound by the First Amendment because it is not a state actor. It also contends that the board diversity explanation requires disclosure only of factual information that is comparable to existing disclosure requirements about board composition. Of petitioner’s legal arguments, this may be the one with the most potential traction.

PRACTICAL SUGGESTIONS AND ADDITIONAL RESOURCES

- Companies should include additional questions in their D&O questionnaires to gather the information required to be reported next year. Nasdaq has provided sample questions here.

- A Nasdaq-listed company that currently has five or fewer directors should consider the implications for the applicability of these new diversity rules before expanding the size of its board, although the addition of a diverse director if required to satisfy the new rules will not in and of itself subject the company to the higher diversity threshold.

- Nasdaq has prepared FAQs, which are available here.