



NASDAQ's Board Diversity Rules

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November 2, 2021

Agenda

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Nasdaq Rules 5605(f) and 5606

- Considering increasing investor demand for greater diversity, the rules are designed “to encourage a minimum board diversity objective...and provide stakeholders with consistent, comparable disclosures concerning...current board composition.”
- NASDAQ-listed companies are encouraged to have at least **two** diverse directors
 - One self-identified as female
 - One self-identified as a member of an underrepresented minority and/or LGBTQ+
 - **Underrepresented minority definition**: an individual who self-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 the foregoing
- Beginning with filings for calendar year 2022, companies are required to annually disclose their demographic board composition information
 - If a company lacks two diverse directors, it must publicly disclose the reason for its lack of board diversity
 - NASDAQ will not assess the merits of explanations – according to NASDAQ’s Chief Legal & Chief Regulatory Office, companies “can choose to disclose as much, or as little, insight into the company’s...diversity philosophy”
- NASDAQ also provides companies with one year of complimentary access to a board recruiting service which extends access to a network of diverse candidates

Board Diversity Matrix

- Board-level diversity statistics will be disclosed using a standardized template – the board diversity matrix
- Disclosures must be made in company’s annual meeting proxy statement or information statement (or Form 10-K/Form 20-F if none of the above is filed)
- A company may publish the board diversity matrix on its website on the date of proxy/information statement filing and submit a link to NASDAQ

| Board Diversity Matrix (As of [DATE]) | | | | |
|---|--------|------|------------|-------------------------|
| Total Number of Directors | # | | | |
| | Female | Male | Non-Binary | Did Not Disclose Gender |
| Part I: Gender Identity | | | | |
| Directors | # | # | # | # |
| Part II: Demographic Background | | | | |
| African American or Black | # | # | # | # |
| Alaskan Native or Native American | # | # | # | # |
| Asian | # | # | # | # |
| Hispanic or Latinx | # | # | # | # |
| Native Hawaiian or Pacific Islander | # | # | # | # |
| White | # | # | # | # |
| Two or More Races or Ethnicities | # | # | # | # |
| LGBTQ+ | # | | | |
| Did Not Disclose Demographic Background | # | | | |

Exceptions

| | |
|------------------------------------|--|
| NEW LISTINGS | <ul style="list-style-type: none">▪ Nasdaq Global Select Market – 1 diverse director by later of (a) one year of listing date or (b) date of filing proxy/information statement AND 2 diverse directors by 2 years of listing date or date of filing proxy/information statement▪ Nasdaq Global Market – same as Global Select Market▪ Nasdaq Capital Market – at least 2 diverse directors by later of (a) two years of listing date or (b) date of filing proxy/information statement for second annual shareholding meeting▪ Boards of 5 or less – one diverse director by (a) later of two years of listing date or (b) filing of proxy/information statement for second annual shareholder meeting |
| SMALLER REPORTING COMPANIES | <ul style="list-style-type: none">▪ Can meet diversity objective with two female directors |
| FOREIGN ISSUERS | <ul style="list-style-type: none">▪ Can meet diversity objective with two female directors▪ Can include “underrepresented individuals” instead of “underrepresented minorities” |
| SMALLER BOARDS | <ul style="list-style-type: none">▪ 5 or fewer directors can meet diversity objective with one diverse director |
| NON-OPERATING ENTITIES | <ul style="list-style-type: none">▪ Completely exempted: certain special purpose acquisition companies, asset-backed issuers, cooperatives, limited partnerships, management investment companies, debt and derivative securities not listed on NASDAQ and closed end funds. Business development companies are <u>not</u> exempt. |

Grace Periods

- A company that ceases to be exempt or that no longer qualifies as a smaller reporting company or foreign issuer must comply with the board diversity rules as of the later (a) one year from disqualification or (b) the date the company files a proxy/information statement for the first annual meeting since the company lost its prior status
- For noncompliance with the rules as a result of a board vacancy, a company has until the later of (a) one year from the date of the vacancy or (b) the date the firm files a proxy/information statement in the year following the vacancy



Empirical Research on Board Diversity

Dozens of studies show a positive relationship between board diversity and improved corporate governance and company performance

- Diversity could lead to higher returns on invested capital, returns on equity and earnings per share
- Having at least one woman on the board of company is associated with a lower likelihood of material weakness in internal controls
- Diversity could reduce “groupthink” and improve decision-making
- Other potential benefits: more transparent disclosures, less information asymmetry, risk mitigation, innovation, investor protection, investor confidence, and corporate culture
- One study examining the impact of board reforms on 41 countries found that comply-or-explain reforms like NASDAQ’s board diversity rule increase shareholder value (Larry Fauver et al.)

However, empirical research is mixed

- Studies have found gender diversity to have a negative impact on firm performance
- Some academic studies demonstrate that board diversity harms financial performance or shareholder value
- One study on board diversity mandates in Norway concluded that they caused a decline in company performance, shareholder wealth and compelled some companies to go private rather than comply (Ahern et al.)
- Cf. A more recent article asserts that the valuation effect of Norway’s quota law was “statistically insignificant” (B. Espen Eckbo et al.)
- Another study found that California’s 2018 law requiring increased board gender diversity has a negative impact on shareholder value (Daniel Greene et al.)
- Increases in board sizes may harm corporate oversight/governance

Multi-Jurisdictional Comparison



California – comply-or-pay

- SB 826 applies to public companies with principal executive offices in California, regardless of where they are incorporated
- Companies with 5 directors or less must have at least 2 female board directors by December 31, 2021
- Companies with 6 or more directors must have at least 3 female directors by December 31, 2021
- Failure to comply may result in fines (none have been imposed)
- AB 979 requires, no later than the close of 2021, that companies have a minimum of 1 director from an underrepresented minority
- Corporations with more than 4 but fewer than 9 directors are required to have 2 directors from underrepresented minorities
- Corporations with 9 or more directors must have at least 3 directors from underrepresented communities



Norway – comply-or-delist

- 2005 law requires companies to have at least 40% of women board members by the end of 2008 - all 460 affected Norwegian companies are complying
- Women now hold 35.5% of the seats on the Norwegian stock index (compared to 19% in the U.S.)



France – comply-or-nullify

- 2011 law: companies with more than 500 employees or with a yearly turnover of \$50 million must have 40% of board seats occupied by women by 2017
- Non-compliance will nullify appointments made in violation of the quota and/or result in the suspension of payment of attendance fees to board members



Germany – comply-or-pay

- In 2015, Germany imposed a mandatory 30% underrepresented sex quota for non-executive boards
- Seats on the board will remain vacant until new elections produce compliant results and failure to meet the quota can result in an administrative fine



UK – no quota

- No mandatory board-level gender quotas – introduction of government-led measures for companies to make boardroom diversity pledges
- These measures have resulted in an increase of female directors on corporate boards



Spain – soft law

- 2005 law requires public companies to have at least 40% of board seats occupied by women by 2015
- No sanctions for failure to comply but there has been an increase in female representation on Spanish boards

Road to SEC Approval – Legal Framework

- **NASDAQ proposed its (1) Board Diversity Proposal and (2) its Board Recruiting Service Proposal to the SEC**
- Under Section 19 the 1934 Securities and Exchange Act (“the Act”), self-regulatory organizations may propose changes in its rules or propose new rules which the SEC “shall approve” if it finds that the rule is consistent with the requirements of the Act
- **Section 6** of the 1934 Act establish the requirements that the SEC must evaluate in registering national securities exchanges – some of the most relevant are:
 - **(b)(4)** requires that national securities exchange rules “provide for the equitable allocation of reasonable dues, fees, and other charges among its members and issuers and other persons using its facilities”
 - **(b)(5)** rules of a national securities exchange are “designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade...to remove impediments to and perfect mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest; and are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers, or to regulate by virtue of any authority conferred by the [Act] matters not related to the purposes of the [Act] or the administration of the exchange”
 - **(b)(8)** rules of national securities exchange must not impose any “burden on competition” that frustrate the purpose of the Act

SEC's Order Approving NASDAQ Rules

- SEC concludes that the exchanges proposed rule changes are consistent with Section 6 of the 1934 Act:
 - Diversity proposal would make comparable information available on the same basis to investors which, in turn, would increase efficiency for investors to gather and use this information → maintenance of fair and orderly markets
 - Diversity proposal is different from board diversity mandates - not compulsory, only disclosure of board composition required → not unfairly discriminatory
 - Disclosures mitigate information asymmetry between large/resourceful investors and smaller investors → promotes just and equitable principles of trade
 - Diversity proposal would not deter capital formation (i.e., discourage companies from going public) because it is not compulsory → company may choose another listing exchange
 - Board Recruiting Service minimizes potential burdens on competition by providing free alternative → equitable allocation of fees, dues, and other charges

Litigation

- The Alliance for Fair Board Recruitment (AFFBR) has filed a petition for review in the U.S. Court of Appeals for the Fifth Circuit
- Whereas there is no substantive briefing, the AFFBR has previewed its arguments in a comment filed with the SEC:
 - 1. Academic research does not support Nasdaq's diversity rule:**
 - a) AFFBR hinges on findings published by the American Enterprise Institute concluding that there is no evidence that board diversity improves performance
 - b) Article questions the legitimacy and credibility of the studies cited by NASDAQ to support its rule
 - 2. NASDAQ's rule is not a mere aspiration/objective**
 - a) Ignores real-world costs of denying companies the right to remain silent on their diversity policies
 - b) Firms will need to spend resources to lawyers and consultants to assess the reputational/legal risks of explanations
 - 3. NASDAQ's diversity rule is inconsistent with the Exchange Act, exceeding its statutory scope**
 - a) Rule is not designed to prevent fraud or protect investors – research only shows correlation, not causation
 - b) Exchanges would be able to micromanage board composition in many other ways (e.g., requiring a certain number of Protestants)
 - c) Rule is not designed to promote just and equitable principles of trade – board diversity has nothing to do with exchanges running just and equitable trading
 - d) Rule is not designed to remove impediments to and perfect the mechanisms of a free and open market system – NASDAQ lacks evidence in showing that the diversity rule will support a market failure in the board-member recruiting process

Litigation (continued)

4. Rule is inconsistent with the Civil Rights Act – encourages firms to recruit board members on the basis of race, gender and sexual orientation

5. Rule violates the Constitution

- a) SEC's approval order is state action and NASDAQ's actions are attributable to the state
 - i. NASDAQ is subject to oversight and control of SEC – “approving, superintending, and enforcing Nasdaq's exchange rules”
 - ii. Diversity rule is only effective upon SEC approval and NASDAQ is subject to SEC sanctions
 - iii. NASDAQ is a private entity that exercises governmental power in ways that affect both the rights of exchange members and securities issuers
 - iv. Diversity rule regulates areas traditionally controlled by states and the SEC

NASDAQ and SEC: under *Blum v. Yaretsky*, 457 U.S. 991, 1004 (1982): SEC's “mere approval” of a proposal is “not sufficient” to convert it into state action

- b) Diversity rule violates the Fifth Amendment
 - i. Violation of EPC because female director rule amounts to sex discrimination
 - ii. Violation of EPC because minority direct rule is discrimination on the basis of race and discrimination based on sexual orientation

SEC: proposal would survive constitutional scrutiny because it is not a mandate

- c) Diversity and disclosure rule violates the First Amendment because it impermissibly compels public companies to speak

NASDAQ: board diversity explanation requires disclosures comparable to existing requirements concerning board composition

Recent Developments

Related Litigation

On Oct. 5, the National Center for Public Policy Research filed a petition in the U.S. Court of Appeals for the Third Circuit, raising similar arguments as the AFFBR according to a press release.

Three lawsuits filed challenging California's board gender diversity statute – one of which has headed for a bench trial. Among them is a lawsuit brought by the AFFBR, alleging violations of the EPC under the 14th Amendment.

There is an increasing number of shareholder derivative suits claiming that directors breached their fiduciary duties by failing to include diverse directors despite making statements of commitment to diversity and inclusion.

Looking Ahead

Disability advocates are pushing the SEC and NASDAQ to include people with disabilities in the board diversity regulations, citing reports that disability sensitive companies perform better in terms of sales and profits.

Board diversity rules are becoming more common: Washington, Colorado, Illinois, Maryland, Pennsylvania and New York have enacted legislation on corporate board diversity. Hawaii, Massachusetts, Michigan and New Jersey are each considering mandatory board diversity legislation.

France's National Assembly passed a bill on May 12, 2021, which will mandate that companies with more than 1,000 employees have at least 30% women as "senior managers and members of management bodies" by 2027, and 40% by 2030. Law is pending approval by the Senate.

QUESTIONS?



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PRACTICE

Jeremiah Williams is a partner in Ropes & Gray's litigation and enforcement practice group, focusing on securities and futures enforcement. In his capacity as a litigator and former government enforcement attorney, Jeremiah has represented and prosecuted individuals and organizations in the financial services industry in both the private and public sectors. His practice focuses on defending entities and individuals in civil and criminal government investigations. Drawing on his deep regulatory knowledge, Jeremiah counsels public companies on updates to risk factors and other public disclosures in light of the COVID-19 outbreak. He also advises asset management clients on regulatory issues and securities-related enforcement

Prior to joining Ropes & Gray, Jeremiah was Senior Counsel in the Division of Enforcement at the U.S. Securities and Exchange Commission. While at the SEC, he was a member of the Asset Management Unit, a specialized group investigating potential misconduct involving registered investment companies and private funds, with a particular focus on the Investment Advisers Act and Investment Company Act. He also previously spent six years in the financial industry, where he worked with derivatives and developed quantitative models used for valuing and hedging complex financial instruments. Jeremiah holds the Chartered Financial Analyst (CFA) designation.

EDUCATION

- JD, *cum laude*, Harvard Law School, 2006
- MBA, MIT Sloan School of Management, 1996
- BA, Yale University, 1994

ADMISSIONS / QUALIFICATIONS

- District of Columbia, 2007
- California, 2006
- Chartered Financial Analyst
- Three-time recipient of the Director's Award in recognition of outstanding contributions to the SEC Division of Enforcement

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