

Capital Markets Alert

December 2024

Fifth Circuit Invalidates Nasdaq Board Diversity Rules

In a 9-8 en banc decision, the Fifth U.S. Circuit Court of Appeals invalidated Nasdaq stock market rules requiring (with certain exceptions and qualifications) each company listed on that exchange to:

- Disclose annually each board member’s self-identified gender and demographic background.
- Have, or explain why the company’s board does not have, at least two “diverse” members.

Under the Securities Exchange Act of 1934 (Exchange Act), a securities exchange cannot adopt any rule without approval of the Securities and Exchange Commission (SEC); but the SEC must disapprove a proposed rule change unless it finds the proposed rule consistent with the requirements of the Exchange Act. The Exchange Act requires an exchange’s rules to, among other things, “promote just and equitable principles of trade, ... [facilitate] a free and open market system and a national market system, and ... protect investors and the public interest”; further, the rules must not “regulate ... matters not related to the purposes” of the Exchange Act.

Although Nasdaq said that the proposed rules were intended, in part, to encourage diversity on listed company boards, the SEC, in approving the rule, held that the proposals would promote the purposes of the Exchange Act cited above by making available information sought by institutional investors and investment managers. Reviewing the history of the Exchange Act in light of the circumstances it was intended to address, the court concluded, however, that Nasdaq’s proposed rules fulfilled none of these purposes and, accordingly, that the SEC lacked authority to approve the rules. The court also held, under the major questions



doctrine, that the SEC had exceeded its authority, given the rules’ enormous economic and political implications, and noted that corporate governance is normally the province of the states.

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