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FIFTH CIRCUIT TOSSES NASDAQ BOARD DIVERSITY RULES AND MAY HAVE SUBSTANTIALLY REDUCED THE SEC'S AUTHORITY TO APPROVE EXCHANGE RULES IN THE PROCESS

December 12, 2024

On December 11, the U.S. Court of Appeals for the Fifth Circuit struck down an SEC approval of an exchange's rules requiring diversity disclosure for listed-company's board of directors in an *en banc* decision in *Alliance for Fair Board Recruitment, et al. v. SEC*. The court held 9-8 that the SEC lacked the power in 2021 to approve the proposed rule of Nasdaq that required Nasdaq-listed companies either have 2 members of its board be female, minority, or LGBTQ+ or explain why not. The contentious cultural issues will get the most publicity, but the majority's treatment of the purposes of the Exchange Act could be the most impactful part of the decision.

Background

An SEC-registered stock exchange like Nasdaq is a self-regulatory organization ("SRO"). Under the Exchange Act, an exchange must adopt rules:

designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, to remove impediments to and perfect the 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 this chapter matters not related to the purposes of this chapter or the administration of the exchange.

15 U.S.C. § 78f(b). Under the same provision, the exchange must file proposed rules with the SEC, who must publish the proposal for notice and comment. After the notice-and-comment period, SEC must

approve the SRO's proposal if "it finds [the proposal] is consistent with the requirements of" the Exchange Act.

In 2020, Nasdaq conducted a study of board diversity among Nasdaq-listed companies based on public disclosures. Investors and investor groups were calling for diversification in the boardroom. Nasdaq then proposed rules that would require disclosure of the diversity of board members related to the board members' race, gender, and LQBTQ+ status. If the board did not have at least one female member and one racial minority or LGBTQ+ member, the company was required to disclose its reason.

The SEC approved the rules after notice and comment, finding that the proposed rules were "related-to" the requirements of the Exchange Act. Specifically, the SEC found that information about the racial, gender, and sexual characteristics of the directors of public companies was important to large institutional investors and investment managers and that disclosures of information important to investors was a purpose of the Exchange Act.

Two groups challenged the SEC decision in the Fifth Circuit. Judges Dennis, Higginson, and Stewart initially ruled in 2023 that the SEC acted within its authority.

The *En Banc* Majority Opinion

When reconsidering that decision *en banc*, the Fifth Circuit reversed. Judge Oldham wrote in an opinion for the majority that exchanges' regulatory powers were limited to matters "related to the purposes" of the Exchange Act. Given the SEC's authority to review SRO rule changes, the majority concluded that the "SEC may not approve even a disclosure rule unless it can establish the rule has some connection to an actual, enumerated purpose of the Act."

The majority rejected several arguments that the proposed rule was related to the requirements of the Exchange Act. But the most interesting and consequential is the majority's vary narrow reading of what disclosures can be related to facilitate "free and open markets." Citing *Loper Bright* for its authority to independently decide what the Exchange Act means by "free and open markets," the majority held, "what Congress meant by a 'free and open market' was a free and open market for securities transactions." It went on to hold, "Equipping investors to make investment and voting decisions might be a good idea, but it has nothing to do with the execution of securities transactions. That means SEC failed to justify its finding that Nasdaq's Proposal is related to the purpose of the [free and open markets] provision."

In addition, the majority independently determined that the SEC's approval of the Nasdaq rule was invalid under the major questions doctrine. The majority concluded the approval of an exchange rule requiring disclosure of the diversity of a list company's board was a major question because Nasdaq is the second-largest stock exchange in the world. It also suggested that any regulations concerning contested cultural issues raised the specter of a major question and indicated that the SEC was entering into new regulatory subjects.

Judge Oldham was joined by judges Elrod, Jones, Smith, Richman, Willett, Duncan, Engelhardt and Wilson.

The Dissent

A dissent by Judge Higginson was joined by Judges Stewart, Dennis, Southwick, Haynes, Graves, Douglas and Ramirez. The dissent focused on the limited scope of both the SEC's review of Nasdaq's proposal and the court's standard of review of the SEC decision. According to the dissent, it was not up to the SEC to displace Nasdaq's business judgment with its own policy priorities. Instead, approval of the rule was required if it was consistent with the requirements of the Exchange Act. And the dissent would hold that the court's role in reviewing the SEC's approval was even more limited: it was only to ask if the SEC's decision not to block the Nasdaq's rule was arbitrary, capricious, or an abuse of discretion.

On the record, the dissent concluded that the SEC's findings that the Nasdaq rule would "contribute to the maintenance of fair and orderly markets' and is therefore 'designed to . . . remove impediments to and perfect the mechanism of a free and open market and a national market system,' is supported by substantial evidence." It pointed to undisputed findings of the SEC that board-level diversity statistics were not widely available and were sought by a wide range of investors.

My Takeaways

1. **The majority takes an unusually narrow view of the purpose of the "free and open markets" provision of the Exchange Act to support its conclusion**. The majority indicates that the only purpose of the "free and open markets" provision of the Exchange Act is to provide efficient securities transactions. More broadly, the only other purpose the majority finds might support any exchange rules is to prevent speculative, manipulative and fraudulent practices. This might reflect a shift in the securities laws. Disclosure rules exist to provide information that helps investors set prices as well, which has historically been viewed as an essential aspect of free and open markets. Many people, including it seems the judges signing onto the majority opinion, believe that investors *should not care* about diversity and that the information does not meaningfully contribute to an efficient market. And if you assume this conclusion is correct, it seems reasonable to also conclude as a factual matter that diversity disclosures are not necessary to "free and open markets." But the majority fails to state this reasoning explicitly or to explain how to reach that result consistent with the court's limited standard of review and a record showing that large, sophisticated investors do care about board diversity. Instead, the majority holds that the exchanges cannot adopt *any* disclosure rules pursuant to the "free and open markets" provision no matter how helpful the disclosures would be to investors, except perhaps if the disclosure is related to discovering potential fraud. Indeed, it seems under the Fifth Circuit's holding that exchanges must tie all rules, including disclosure rules, to narrowly defined categories of fraud prevention or efficient trade execution and nothing else.

2. **The dissent seems correct that additional disclosure rules are consistent with the Exchange Act and better left to competition between exchanges in the market**. Without regard for the subject of the specific disclosures at hand, I find persuasive the dissent's argument that exchanges should be permitted to adopt rules requiring disclosure of information that they conclude investors want disclosed. Access to material information has historically formed a bedrock of America's "fair and

orderly markets" by reducing information asymmetries and facilitating efficient securities markets and allocation of capital. And historically, we have defined what information is material by reference to what investors believe is important. Significantly, unlike their federal government regulators, issuers have choices on what exchange they choose to list. That provides a market solution to a question inherently tied to the market itself-let issuers and investors decide whether the benefits of a disclosure requirement imposed by an exchange is worth the compliance costs. That competitive market is better suited to determine what additional disclosures beyond those required of all public companies best facilitate fair and orderly markets. The notion of competition in the market of exchanges is not hypothetical. For example, the Texas Stock Exchange, which hopes to be listing stocks by 2026, is anticipated to have a very different approach to corporate governance disclosures that would be a meaningful alternative.

3. **The majority is probably correct that the purpose of the rule was more about encouraging governance changes than disclosure and that is not a purpose of the exchanges under Exchange Act**. A much more persuasive argument was the majority's conclusion that the rule was primarily about encouraging diverse boards rather than disclosure. The Nasdaq itself created a lengthy record indicating that it wanted to change the diversity of boards, not merely provide investors tools to evaluate issuers. The majority made a persuasive case that encouraging diverse boards was not something that Nasdaq could pursue through its rules under the Exchange Act.

You can read the opinion here.

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