

FIFTH CIRCUIT PANEL UPHOLDS NASDAQ BOARD DIVERSITY DISCLOSURE RULES

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A Fifth Circuit panel recently upheld Nasdaq's diversity disclosure rules after petitioners challenged them under the First and Fourteenth Amendments and the Administrative Procedure Act (APA). *Alliance For Fair Board Recruitment v. SEC*, 5th U.S. Circuit Court of Appeals, No. 21-60626. The court held that the Securities and Exchange Commission (SEC) did not act arbitrarily or capriciously under the APA in approving the rules, which require Nasdaq-listed companies to disclose diversity information about their board members. The case was decided by a panel of three Fifth Circuit judges, each of whom was appointed by Democratic presidents. Petitioners now seek *en banc* review from all sixteen judges on the Fifth Circuit, which is generally viewed as the most conservative U.S. Court of Appeals.

The Fifth Circuit panel rejected the petitioners' First and Fourteenth Amendment challenges to the Nasdaq board diversity rules because Nasdaq is not a government entity and there was no "close nexus" between the government and Nasdaq's board diversity rulemaking.

BACKGROUND

The Nasdaq board diversity rules require Nasdaq-listed companies to disclose diversity data with respect to board members each year. Nasdaq-listed companies may use a board diversity matrix template provided by Nasdaq or a substantially similar format. The board diversity matrix must disclose the total number of directors on the board, as well as the number of directors self-identifying certain characteristics: gender identity; race and ethnicity (African American or Black, Alaskan Native or Native American, Asian, Hispanic or Latinx, Native Hawaiian or Pacific Islander, White, or Two or More Races or Ethnicities); and LGBTQ+ status. See [Reminder: Initial Board Diversity Matrix Now Required for Nasdaq Companies](#) and [It's Official: SEC Approves Nasdaq Board Diversity Proposal – Comply or Explain Why Not](#).

CONSTITUTIONAL CHALLENGES

The petitioners in *Alliance for Fair Board Recruitment* argued that Nasdaq's board diversity disclosure rules violate the prohibition on discriminatory laws and restraints on free speech under

the U.S. Constitution. For the Nasdaq rules to be subject to constitutional scrutiny under the First and Fourteenth Amendments, the petitioners must show that the rules involve “state action” on Nasdaq’s part. The petitioners argued that the First and Fourteenth Amendments applied to the Nasdaq board diversity rules because 1) Nasdaq is a government entity and 2) Nasdaq’s rules are attributable to the government as a result of the SEC’s approval of the Nasdaq rules, and therefore constitutional constraints applied to the rulemaking process.

The court rejected both arguments. First, the court held that Nasdaq was not a government entity or state actor, noting that the Supreme Court has held that a private entity does not become a state actor merely by virtue of being regulated. Second, the court held that for actions of a regulated entity to constitute “state action,” there must be a sufficiently close nexus between the state and the challenged action of the regulated entity. This close nexus generally only exists in limited circumstances such as when (i) the private entity performs a traditional, exclusive public function; (ii) the government compels the private entity to take a particular action; or (iii) the government acts jointly with the private entity. The court did not find any of the three indicia of state action to be presented by the Nasdaq board diversity rules, and accordingly held that the rules were not state action subject to constitutional scrutiny.

CHALLENGES TO SEC’S AUTHORITY

The court held that the SEC’s approval of Nasdaq’s board diversity rules was not “arbitrary and capricious” and did not violate the APA. The court examined whether the SEC’s decision was based on a consideration of the relevant factors and whether there was a clear error of judgment. The court found that the SEC’s approval was based on the following relevant factors: (i) the rules contributed to the maintenance of fair and orderly markets, (ii) the rules were not unfairly discriminatory to foreign issuers, (iii) the benefits of disclosure outweighed the costs, (vi) the SEC conducted an independent review, and (v) Nasdaq could use a partnership for the board recruiting services.

PETITIONERS’ NEXT STEPS

One of the petitioners has filed a petition for review *en banc* by all sixteen of the Fifth Circuit judges. The petition for review stated that the panel’s ruling allowed “racial discrimination and controversial disclosures.” While the panel that initially upheld Nasdaq’s rules consisted entirely of judges appointed by Democratic presidents, twelve of the sixteen judges on the Fifth Circuit were appointed by Republican presidents.

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