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ALERT

Fifth Circuit Overturns SEC Approval of Nasdaq’s Board Diversity Rules

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On December 11, 2024, the United States Court of Appeals for the Fifth Circuit, in a lengthy opinion, vacated the U.S. Securities and Exchange Commission’s (SEC) approval of Nasdaq’s board diversity rules in *Alliance for Fair Board Recruitment v. SEC*. The court found Nasdaq’s regulations to be inconsistent with the purposes of the Securities Exchange Act of 1934 (Exchange Act) and concluded that the SEC’s decision approving such rules was “arbitrary, capricious, an abuse of discretion, or otherwise not in accordance with law” under the Administrative Procedure Act (APA). This decision, coupled with the coming change in Administration, will likely lead to a realignment of environmental, social, and governance (ESG) requirements in 2025.

Nasdaq’s Rules and the SEC’s Approval

In December 2020, Nasdaq proposed three board diversity-related rules that Nasdaq-listed companies would have to comply with:

- Disclosure Rule: Required companies to disclose the diversity characteristics of their directors.
- Diversity Rule: Mandated generally that companies either have at least two diverse directors or explain noncompliance with this requirement.
- Recruiting Rule: Offered a board recruiting service to help companies meet diversity goals.

The SEC approved these rules on August 6, 2021, determining that they aligned with the purpose of the Exchange Act and thus could be adopted by Nasdaq under its self-regulatory authority under the Exchange Act. After the rules became effective in August 2022, Nasdaq-listed companies began making required disclosures. In

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October 2023, a Fifth Circuit panel found that the SEC's approval of the diversity rules comported with the Exchange Act and was lawful under the APA. In the panel's view, the SEC had a limited role in merely approving the regulations established by a non-government actor (i.e., Nasdaq), and the SEC adequately fulfilled that role in approving these rules.

The Fifth Circuit's Decision

But the full Fifth Circuit took the case *en banc* and ultimately disagreed in a 9-8 decision. The court held that the SEC's approval of the Disclosure and Diversity Rules was arbitrary and capricious under the APA because the SEC failed to adequately justify how those rules advanced the Exchange Act's goals. In the *en banc* majority's view, the Exchange Act focused on preventing fraud, protecting investors, and providing economic stability and fair competition in securities markets. Rules requiring the disclosure of racial, gender, and other personal characteristics of board members fell outside those objectives. While the SEC argued the rules would provide accurate information that could be important to some investors, the court found that justification alone was insufficient. The court also pushed back on Nasdaq and the SEC's assertion that the rules were not intended to reshape corporate boards. The challenge to Nasdaq's Recruiting Rule was dismissed as moot.

Applying the major questions doctrine to "confirm[]" its interpretation of the Exchange Act – a doctrine "as old as the administrative state itself," the *en banc* majority added that the Disclosure and Diversity Rules addressed matters of "staggering" economic and political significance outside the SEC's ordinary regulatory domain that intruded into areas of traditional state regulation, thus requiring the SEC to point to "clear congressional authorization" to justify approving such rules. But the SEC instead relied on "vague" language in the Exchange Act, which could not support its approval of these rules.

Immediate Reaction

Although the SEC has not yet announced whether it intends to appeal the decision, Nasdaq – which had intervened in the case to defend its rules – notified listed companies the day after the *en banc* decision that it "respect[s] the Court's decision" and does "not intend to seek further review."

Key Takeaways

Given the incoming Presidential Administration's agenda and Nasdaq's decision not to appeal, the SEC is unlikely to petition the U.S. Supreme Court to review the Fifth Circuit's decision. Nasdaq-listed companies should review disclosures, proxy statements, websites, and marketing materials in light of the ruling to determine whether and to what extent board-level diversity information should be included going forward. While Nasdaq will no longer require this reporting, companies should assess whether board diversity statistics should be publicized to comply with state laws, internal promises, or in response to investor demands.

More broadly, the *en banc* court's "major questions" analysis contributes to the current debate about the validity of that doctrine as an interpretive tool. The doctrine has been a focus in several recent Supreme Court decisions, with dissenting Justices criticizing the Court for deploying it and concurring Justices defending it. The *en banc* Fifth Circuit's analysis adds to this discussion in support of the doctrine, characterizing it as a background rule against which the administrative state should be judged.

Further, the decision is one of many challenges facing Biden-era disclosure requirements implemented by the SEC under Chairman Gensler. Paul Atkins, President-elect Trump's pick to chair the SEC, has been a vocal critic of the Commission's climate disclosure rule, which would require publicly traded companies to report details about carbon emissions and the risk climate change poses to their businesses. The SEC's cybersecurity disclosure requirements may also be revisited under the incoming Administration, especially given criticism from dissenting Commissioners in recent enforcement actions. And the SEC will likely scrap its plan to issue a notice of proposed rulemaking regarding human capital disclosures.

At bottom, a rebalancing of ESG disclosure regulations in the months to come is likely, providing companies with increased flexibility in determining which non-financial information disclosures best suit their investors and businesses. That rebalancing should also result in the Commission refocusing on its core mission to protect investors and securities markets.