

Nasdaq's board diversity rules: Inclusivity is good business

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Historically, corporate boardrooms have been inhabited almost exclusively by white men. Recently, female and minority representation on corporate boards has increased, but many companies have refused to adapt, and concerning trends remain.

Citing slow progress toward board diversity, Nasdaq proposed a new Rule 5606(f), which requires that companies whose stock is traded on the exchange have diverse board members or disclose why their board is not diverse.

Women of color are the most underrepresented group in Fortune 500 boardrooms, holding just 4.6% of board seats. Also troubling, minority men gained no substantive increase in their rate of representation on Fortune 100 and 500 company boards in the past decade. These trends suggest that at many companies, white men still don't want to share the boardroom.

Citing slow progress toward board diversity, Nasdaq proposed a new Rule 5606(f), which requires that companies whose stock is traded on the exchange have diverse board members or disclose why their board is not diverse. The Securities and Exchange Commission approved the Rule on Aug. 6, 2021, and it has been heralded as a significant step toward corporate equality and a boon to investors calling for social reform. Opponents of the Rule have lambasted it as unconstitutionally discriminatory — against white males — and waged a recent legal challenge against it. Meanwhile, the evidence of the social and economic benefits of diverse boards is overwhelming.

The proposed new Nasdaq Rule 5606(f), which is scheduled to go into effect in August 2023, would require companies to (i) publicly disclose board-level diversity statistics on an annual basis using a standardized matrix template and (ii) have, or disclose why they do not have, a minimum of two diverse board members. The diverse board members must include at least one person who self-identifies as female and one person who self-identifies as an underrepresented minority or part of the LGBTQ+ community.

Per Adena Friedman, President and CEO of Nasdaq, in a statement on Dec. 1, 2020, the goal of the proposed Rule is to “provide a transparent framework for Nasdaq-listed companies to present their board composition and diversity philosophy effectively to all stakeholders; we believe this listing rule is one step in a broader journey to achieve inclusive representation across corporate America.”

The Rule is drafted as a “comply or explain” option, rather than a rigid “quota” requirement, which many believe will prioritize shareholder engagement. As Gary Gensler, chair of the Securities and Exchange Commission, explained in an Aug. 6, 2021, statement, “These rules will allow investors to gain a better understanding of Nasdaq-listed companies’ approach to board diversity, while ensuring that those companies have the flexibility to make decisions that best serve their shareholders.”

If a Nasdaq-listed company fails to disclose its non-compliance with the Rule's diversity requirement, it may be liable under the federal securities laws for its omission.

While acknowledging the flexibility of Nasdaq's approach, commentators have observed that the Rule all but ensures compliance and change: As Rosabeth Moss Kanter (Harvard Business School) and Andrea Silbert (Eos Foundation) explained in a Nov. 23, 2021, opinion article for the Boston Globe, “Mandates enforce intentionality, and intentionality works, as we've seen in the rise of the percentage of women board members from 12 percent to 31 percent from 2000 to 2019.” Kelly Williams (founder of Private Equity Women Investor Network) put it bluntly at a Sept. 14, 2021, panel hosted by the Beyond #MeToo Working Group, “What gets measured gets done.”

There is compelling evidence that diversity in the boardroom provides tangible business benefits. Several studies cited by Nasdaq in announcing Rule 5606(f) show that boardroom diversity directly benefits firm performance, including improved shareholder

engagement, public securities disclosure accuracy, and a boost in companies' ability to attract and retain talent. Consultants at McKinsey & Company also found that companies in the top quartile of racial and ethnic diversity outperformed those in the fourth quartile in profitability by a whopping 36%.

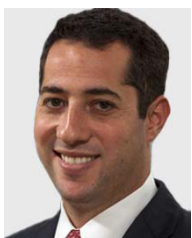
Rule 5606(f) also better arms investors challenging the accuracy of corporations' representations about their board diversity. To date, board composition challenges have largely floundered in the courtroom, including challenges brought against Qualcomm, Facebook, Oracle, NortonLifeLock, Monster Beverage, Gap, Danaher, Advanced Micro, and Cisco, among others.

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The Rule would make claims like these easier to pursue — if a Nasdaq-listed company fails to disclose its non-compliance with the Rule's diversity requirement, it may be liable under the federal securities laws for its omission. Similarly, if a Nasdaq-listed company lies about its reason for its lack of diversity, it could be held accountable for its misrepresentations on the subject under state and federal securities laws.

The proposed Rule 5606(f) is not without its detractors. In late December 2021, 17 state Attorneys General, led by Texas Attorney General Ken Paxton, submitted a legal brief in support of an action challenging the constitutionality of Rule 5606(f). Petitioners argued in *Alliance for Fair Board Recruitment v. Securities Exchange Commission*, docket No. 21-60626, that the Nasdaq rule discriminates against corporate board members based on the protected classes of race and sex by instituting an unconstitutional "quota" system. The case is currently pending before the 5th U.S. Circuit Court of Appeals.

About the authors



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While we await the Fifth Circuit's decision on this legal challenge, the active discourse on not just the need for Rule 5606(f) itself, but on the need for corporate America to embrace diversity at all levels of business, remains very alive. The outcome of the appeal, and the fate of Rule 5606(f), will not be determinative of the war on inequity.

The institutional investor community is increasingly recognizing that inclusivity is not just good for society, it is also good for business. As Pamela Gibbs, Director of the SEC's Office of Minority and Women Inclusion, recently observed at the Beyond #MeToo Working Group panel, "Diversity matters to most people now and that's the change. That's how we have to pivot as a country."

While Rule 5606(f) is an undeniable step in the right direction, it is neither enough nor perfect. As an initial matter, the Rule's success relies on diverse board members' willingness to publicly disclose their status as such in regulatory filings. But even if Rule 5606(f) does compel disclosure of individuals' minority status, women and minorities remain severely underrepresented, and progress is slow.

There are a multitude of ways — including amendments to corporate bylaws — for investors to improve boardroom diversity and, consequently, improve business performance. Investors should throw their support behind board diversity and, if Nasdaq's Rule is somehow blocked, insist that corporate America institute the changes and provide the disclosures the Rule would otherwise require.

Responsibility also falls to the corporate boards themselves, which can effectuate change by updating homogeneous hiring referral programs, providing financial incentives to corporate officers to increase diversity, and ensuring that diverse talent has as many promotional opportunities as non-diverse candidates do. Monumental change will require companies, regulators, and investors to work together toward this shared goal. The first step is to realize that when companies are diverse, everyone wins.

Jonathan D. Uslaner is a regular contributing columnist on securities litigation for Reuters Legal News and Westlaw Today.

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