
Nasdaq Announces Rule Request to Improve Board Diversity

Nasdaq recently filed a [proposal](#) with the U.S. Securities and Exchange Commission (“SEC”), seeking approval of a rule requiring Nasdaq-listed companies to appoint diverse directors and make certain specific disclosures about their board diversity. Specifically, Nasdaq proposed the following new rules: (i) Rule 5605(f) (Diverse Board Representation) and (ii) Rule 5606 (Board Diversity Disclosure), as well as (iii) certain conforming changes to rules that are implicated by the proposals. If approved, the new rules would affect each of the more than 3,300 Nasdaq-listed companies and perhaps lead to other exchanges following suit.

In the 271-page Notice of Rule Proposal, Nasdaq provides a comprehensive review and analysis of the current status of board diversity, applicable rules and policies, implications of board diversity and the available studies. Based on its research, Nasdaq concludes the proposed rules are necessary to bring much needed transparency and consistency to investors. Opining that the existing SEC rules fail to provide the clarity it believes investors are clamoring for, Nasdaq explains the proposed rules are well within its mission to foster investor protection and its rulemaking authority so long as they do not conflict with SEC rules.

Throughout the rule notice, Nasdaq underscores that “diversity in the boardroom is good corporate governance.”¹ Nasdaq cites multiple studies that have found heterogeneous boardrooms to be positively associated with “more transparent public disclosures and less information asymmetry; better reporting discipline by management; a lower likelihood of manipulated earnings through earnings management; an increased likelihood of voluntarily disclosing forward-looking information; a lower likelihood of receiving audit qualifications due to errors, non-compliance or omission of information; and a lower likelihood of securities fraud.”² Board diversity is further associated with higher average earnings growth³, improved financial performance⁴, higher credit ratings,⁵ and reduced stock volatility.⁶

¹ *Notice of Proposed Rule Change* (December 1, 2020), at 132.

² *Id.*, at 9.

³ A 2020 study by The Carlyle Group of its portfolio companies found that, “after controlling for industry, fund and vintage year, companies with diverse boards generate earnings growth that’s five times faster, on average, with each diverse board member associated with a 5% increase in annualized earnings growth.” *Id.* at 17.

⁴ Among the many findings cited by Nasdaq, illustrative examples include: FCLTGlobal’s 2019 study which found that boards in the 80th percentile for diversity “added 3.3 percentage points to return on invested capital” as compared to boards in the 20th percentile *Id.*, at 17; McKinsey’s 2015 findings that “companies in the top quartile for racial/ethnic diversity were 35 percent more likely to have financial returns above their national industry median” *Id.*; Credit Suisse’s 2014 findings that “companies with at least one woman on the board had an average sector-adjusted return on equity (“ROE”) of 12.2%, compared to 10.1% for companies with no female directors, and average sector-adjusted ROEs of 14.1% and 11.2%, respectively, for the previous nine years.” *Id.*, at 18.

⁵ A 2019 Moody’s study found that 28% of board seats at Aaa-rated companies were held by women, while at Ca-rated companies, that percentage was under 5%. *Id.*, at 20.

⁶ *Id.*, at 30, (citing Gennaro Bernile et al., *Board Diversity, Firm Risk, and Corporate Policies* (March 6, 2017), available at: <https://ssrn.com/abstract=2733394>)

Recognizing that the U.S. ranks 53rd among countries in terms of board gender diversity⁷, Nasdaq believes board diversity is “a critical business and market imperative.”⁸

Proposed Rule 5605(f) will mandate that each Nasdaq-listed company either (i) have at least two “Diverse” directors on its Board, including one female-identified director and one director who is either an Underrepresented Minority or LGBTQ+, or (ii) explain why they have not met the mandate.⁹ “Diverse” is defined as (i) female, (ii) Underrepresented Minority or (iii) LGBTQ+. The definition of “Underrepresented Minority” is consistent with the categories that companies are required to report to the EEOC, and is defined as “Black or African American, Hispanic or Latinx, Asian, Native American or Alaska Native, Native Hawaiian or Pacific Islander or two or more races or ethnicities.”¹⁰ The LGBTQ+ definition is based on the definition contained in the recently adopted California board diversity law (A.B. 979)¹¹, but has been expanded to include members of the queer community. Notably, the requirement for two directors does not allow companies to double-count their potentially Diverse board candidates.

If a company chooses not to add Diverse directors to its board, it must provide an explanation as to why it has not done so. Nasdaq notes that this explanation could provide an opportunity for a company to show other types of diversity that they have considered in creating their board such as nationality, veteran’s status or disability, three otherwise protected classes that are not within the proposed definition of “Diverse” for purposes of the rule.

Recognizing that these changes can take time, Nasdaq recommends a staggered phase-in period for the rules, with two years to appoint one Diverse director and four years to appoint a second. If a company fails to comply or appropriately disclose as require, the company will have until the latter of the next annual shareholder meeting or 180 days to comply by adding Diverse directors or disclosure. Certain companies, such as Foreign Issuers¹² and Smaller Reporting Companies¹³ have differing requirements for what their boards must meet and a small subset of companies is exempt from the requirements.¹⁴

Nasdaq further recognizes the lack of current, consistent disclosure of board diversity statistics. Proposed Rule 5606 seeks to remedy this by mandating annual disclosure of each director’s self-identified diversity

⁷ *Id.*, at 32

⁸ *Notice of Proposed Rule Change*, at 32

⁹ This “comply or explain” approach has been adopted in Finland, New Zealand and Canada. *Id.*, at 76

¹⁰ *Id.*, at 3

¹¹ A.B. 979, which was approved on September 30, 2020, applies to any “publicly held domestic or foreign corporation whose principal executive office is located in California.” The law contemplates two separate phase in periods; by December 31, 2021, companies should have at least one member of an “Underrepresented Community” on their Board, and by December 31, 2022, companies will be required to meet a certain threshold of “Underrepresented” directors based on the total size of the board (up to three such directors if a board’s size is nine people or greater). Assembly Bill No. 979, available at https://leginfo.ca.gov/faces/billTextClient.xhtml?bill_id=201920200AB979

¹² In regards to Foreign Issuers, Nasdaq proposes a different definition of “Diverse”, as what is diverse in the United States may not be so in other cultures. The proposed definition for Foreign Issuers is “an individual who self-identifies as one or more of the following: Female, LGBTQ+, or an underrepresented individual based on national, racial, ethnic, indigenous, cultural, religious or linguistic identity in the Company’s home country jurisdiction.” *Id.*, at 263. The standards for board composition remain the same: one female director and one “Diverse” director, or otherwise explain why they cannot meet the mandate. Because self-identified women are defined as Diverse for Foreign Issuers, a Foreign Issuer can meet the requirement by having two women on their board.

¹³ Smaller Reporting Companies are still required to have two Diverse directors, one of whom identifies as female. However, the second director can be either Diverse (e.g., LGBTQ+ or an Underrepresented Minority) or female for purposes of meeting the mandate.

¹⁴ Specifically, “Exempt Companies” is defined as: “acquisition companies listed under IM-5101-2; asset-backed issuers and other passive issuers (as set forth in Rule 5615(a)(1)); cooperatives (as set forth in Rule 5615(a)(2)); limited partnerships (as set forth in Rule 5615(a)(4)); management investment companies (as set forth in Rule 5615(a)(5)); issuers of non-voting preferred securities, debt securities and Derivative Securities (as set forth in Rule 5615(a)(6)); and issuers of securities listed under the Rule 5700 Series.” *Id.*, at 69.

characteristics in a Board Diversity Matrix¹⁵, to the extent permitted by privacy and other applicable laws. The increase in disclosure aims to standardize board demographic data and to “streamline[e] investors’ desires for clear, complete and consistent disclosures.”¹⁶ Companies would have one year from the date of SEC approval to comply with Rule 5606.

While Proposed Rules 5605 and 5606 are still pending SEC approval, by this rule notice Nasdaq has placed itself at the forefront of the increasing pressure on companies to improve board diversity.

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If you have any questions about the issues addressed in this memorandum, or if you would like a copy of any of the materials mentioned, please do not hesitate to call or email Helene R. Banks at 212.701.3439 or hbanks@cahill.com or Emma O’Hara at 212.701.3150 or ehara@cahill.com; or publications@cahill.com

¹⁵ Nasdaq provides a template for the Board Diversity Matrix at *Id.*, at 57-8.

¹⁶ *Id.*, at 61.

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