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Nasdaq's Board Diversity Directive

Corporate board directors have critical roles in the operation of publicly traded firms. Some of those responsibilities include (1) decisionmaking as fiduciaries on behalf of the company's shareholders and oversight of senior corporate management; (2) finding, hiring, and firing senior executives; (3) formulating senior executive compensation; (4) voting on corporate acquisitions and mergers; (5) determining dividend policy; and (6) deciding on whether to authorize stock buybacks.

Research has been conducted on board diversity. For example, in 2021, the Conference Board, a business membership and research group, reported that among the firms in the Russell 3000 index (a stock index that encompasses the majority of publicly traded firms with 98% of the weighted market capitalization of the stock market in mid-2021) that disclosed their board diversity statistics: (1) women represented 24.4% of board members; (2) African Americans represented 10.9% of board members; (3) Hispanics represented 4.4% of board members; and (4) Asian, Hawaiian, and Pacific Islanders represented 4.9% of board members. Many observers assert companies would benefit from greater diversity on their boards. However, rules requiring certain disclosures from companies about diversity are controversial. This In Focus examines one such rule implemented by the Nasdaq U.S. exchange.

Nasdaq's Diversity Directive

Nasdaq is the second-largest stock exchange in the world, with approximately 3,700 firms listed on it. Among those are Costco, T-Mobile U.S., Qualcomm, Broadcom, Cisco Systems, PepsiCo, Adobe, Intel, Comcast, Netflix, PayPal, Nvidia, Facebook, Tesla, Alphabet, and Amazon.

In December 2020, Nasdaq stated that it intended "to provide stakeholders with a better understanding of the [listed] company's current board composition and enhance investor confidence that all listed companies are considering diversity in the context of selecting directors." To that end, it proposed new company listing rules that the Securities and Exchange Commission (SEC) approved in August 2021 as new Nasdaq Rule 5605(f). Some observers think that the protocol will pressure firms to add more diverse directors due to their public nature.

Upon voting to approve the rules, SEC Chair Gary Gensler remarked: "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…. These rules reflect calls from investors for greater transparency about the people who lead public companies, and a broad cross-section of commenters supported the proposed board diversity disclosure rule."

What the New Rule Will Do

Under the new Nasdaq rule:

- Listed firms will be required annually to publicly disclose board member diversity based on their self-identification (non-Binary, African American, Alaskan Native or Native American, Asian, Hispanic or Latinx, Native Hawaiian or Pacific Islander, White, Two or More Races or Ethnicities, Underrepresented Individual in the home country of foreign issuers).
- Most Nasdaq-listed companies will be required to have, or explain why they do not have, at least two diverse directors, which will include a director who self-identifies as female and one who self-identifies as either an underrepresented minority (one of the aforementioned groups) or as LGBTQ+.
- Firms with boards of five or fewer directors will only be required to have at least one self-identified diverse director. If such firms have such a small board before becoming subject to the board diversity rule, they will be allowed to add a sixth diverse director in fulfillment of the requirement for smaller boards. If, however, a company board grows to more than six directors, it will be subject to the two-diverse-directors mandate.
- An additional *Board Recruiting Service Rule* will give Nasdaq-listed firms without a specified number of diverse directors access to a service that provides a network of diverse director candidates for one year.
- If a firm fails to provide for the specified number of diverse directors or to explain why it has not, it will have until its next annual meeting or 180 days from the event that caused the deficiency to cure the deficiency (such as the exit of a diverse director). A company that did not regain compliance within the applicable cure period would be subject to delisting by the exchange.

The phase-in date for the board diversity data disclosure is August 8, 2022, or the date that a company files its proxy or annual statement for the year. The earliest phase-in date for the protocol in which Nasdaq-listed companies must have, or must explain why they do not have, (1) at least one diverse director is August 7, 2023, or the date the company files its proxy or information statement for 2023; and (2) at least two diverse directors is August 6, 2025, or the date the company files its proxy or information statement for 2025.

In its December 2020 proposal, Nasdaq reported that it believed that much more than a majority of its listed companies had made noteworthy progress in improving boardroom gender diversity and had at least one woman director. However, in a survey conducted the same year, the exchange reportedly found that three-quarters of its listed firms would not satisfy the new board diversity rules. That finding did not reflect the fact that firms will be permitted to avoid the diverse director requirements by explaining why they were unable to fulfill it. When that occurs, the exchange will not judge their merits.

Alternatively, Nasdaq's chief rival, the New York Stock Exchange, has created the *Board Advisory Council* composed of CEOs from some of its listed firms. Its goal is to use the executives' personal networks to identify diverse board candidates and expose them to listed firms.

Supporters and Critics

Nasdaq's reform has attracted both support and criticism. Among those lending general support are the American Civil Liberties Union, the AFL-CIO, the Council of Institutional Investors, the Forum for Sustainable Growth, the U.S. Chamber of Commerce, the Hispanic Chamber of Commerce, the California State Teachers Retirement System, the Pennsylvania state treasurer, Goldman Sachs, Microsoft, and Facebook.

In a letter to Nasdaq on January 7, 2021, Senator Sherrod Brown, chair of the Senate Banking, Housing, and Urban Affairs Committee, and 15 other Senate Democrats expressed support for the proposed reform. In joint correspondence to the SEC, the Representatives Gregory Meeks and Caroline Maloney also lent their support to the proposal. After the SEC approval, Senator Brown and Chairwoman Maxine Waters of the House Committee on Financial Services praised the decision.

There has been some targeted criticism that the rule is insufficiently inclusive with respect to the disabled and African Americans. It came from, respectively, various disability rights advocates and the National Urban League. Among those expressing more general criticism were the Competitive Enterprise Institute, Judicial Watch, the Heritage Foundation, former SEC Chairman Arthur Levitt Jr., and some academics.

On February 12, 2021, Senator Pat Toomey, the ranking member of the Senate Banking, Housing, and Urban Affairs Committee, and the committee's other Republican members wrote a joint letter to then-acting SEC chair Allison Herren Lee criticizing the proposed reform. After the SEC approval, Senator Toomey said, "Corporate board rooms, like all organizations, can benefit from a diversity of perspectives, but NASDAQ's one-size-fits-all quota misses the mark."

Some Key Supportive Arguments

According to Nasdaq, a growing number of investors—including major asset managers Vanguard, State Street Advisors, and BlackRock—are increasingly calling for more diverse corporate boards. The following are among the significant supportive arguments for the reform:

- One Nasdaq review of an extensive body of academic research concludes that diverse boards are positively associated with improved corporate governance and financial performance.
- For investors who favor diverse boards, the required disclosures could help inform their decisions on issues related to corporate governance, including election of directors. (SEC)
- For investors who do not think that there is a benefit to diverse directors, the disclosure requirement could help them decide to vote to keep the existing board. (SEC)
- According to some research (Fauver, Hung, Li, and Taboada, 2017), comply-or-explain corporate governance measures similar to the Nasdaq listing reform were generally found to have increased shareholder wealth more than outright corporate governance mandates did.

Some Key Critical Arguments

Significant critical arguments against the reform include the following:

- As a whole, the research on the impact of board diversity on their firms is generally inconclusive, an indication that questions on the effect of mandatory changes still remain. (SEC)
- The required disclosures do not meet the fundamental test of investor materiality in the evaluation of a company's performance as they are irrelevant to such considerations. (Republican members of the Senate Banking, Housing, and Urban Affairs Committee)
- It will pressure listed firms into subordinating critical director attributes "such as knowledge, experience, and expertise" in the selection of board members. (Senator Pat Toomey)
- Research (Gormley, Gupta, Matsa, Mortal, and Yang, 2021) found that market forces (as opposed to mandates) driven by the campaigns of Blackrock, State Street, and Vanguard for greater board diversity resulted in adding two-and-a-half times as many women directors in 2019 than existed three years earlier, many of whom subsequently attained influential board positions.
- The SEC's approval process failed to meet the test put forth in an earlier judicial opinion, which found that the agency had failed to fulfill its obligations under the Securities Exchange Act of 1934 (P.L. 73-291), which regulates exchanges, by not conducting "reasoned analysis" during the approval process for another proposed rule. (SEC Commissioner Elad Roisman)

A Court Challenge

On August 9, 2021, a group of corporate directors, the Alliance for Fair Board Recruitment, challenged the SEC's approval of the Nasdaq rule before the Fifth Circuit Court of Appeals. It argued that firms would be compelled to discriminate on the basis of gender, race, and sexual orientation.

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