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Nasdaq Proposes New Diversity Rule Requiring Nasdaq-Listed Companies to Diversify Their Boards or Risk Delisting

8 Min Read

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Recent events have spurred a social justice movement that has called for companies to commit to inclusion and diversity, specifically in the composition of their boards of directors.* In light of the foregoing, on December 1, 2020, Nasdaq filed a proposal with the U.S. Securities and Exchange Commission ("SEC") that, if approved by the SEC, would condition a company's continued listing on Nasdaq's U.S. exchange on the satisfaction of certain board diversity and disclosure requirements. In proposing this rule, Nasdaq conducted its own internal study on the diversity of Nasdaq-listed companies, including a review of more than two dozen third-party studies on the effects of board diversity. Nasdaq concluded that a positive correlation exists between diverse boards and improved corporate governance and financial performance.

Nasdaq's proposed rule would impose two action items for companies listed on Nasdaq's U.S exchange. First, the proposed rule would require Nasdaq-listed companies to disclose standardized statistical information on the diversity of each company's board of directors through each director's optional self-identification of certain diversity characteristics—such as race/ethnicity, gender, and LGBTQ+ status.[1] Companies listed on Nasdaq's U.S. exchange will have one year after the SEC approves the proposed rule to comply with this disclosure requirement. Second, Nasdaq's proposed rule would require each Nasdaq-listed company to either (i) have at least one director who self-identifies as a woman, without regard to such director's designated sex at birth, and have at least one director who self-identifies as either LGBTQ+ or a racial or ethnic minority consistent with the categories established by the Equal Employment Opportunity Commission, or (ii) explain why the composition of its board does not comply with the diversity requirements listed in (i).[2] That explanation would also need to be included on the company's website and in its proxy statement or information statement for its annual meeting of stockholders. Nasdaq will phase in the application of this portion of its proposed rule. Within two calendar years following SEC approval of the proposed rule, Nasdaq-listed companies must have at least one Diverse (defined in the proposed rule to include those who self-identify as a woman, LGBTQ+, or a racial or ethnic minority) director (or explain and disclose why such company does not have a Diverse director); and within four[3] calendar years following SEC approval of the proposed rule the companies must have at least two Diverse directors (or explain and disclose why such company does not have two Diverse directors). Additionally, any newly listed company on Nasdaq's U.S exchange that was not subject to a similar requirement from another national securities exchange will have one year from the date of listing (following the transition periods mentioned above) to satisfy these board diversity requirements.

If a company listed on Nasdaq's U.S. exchange fails to comply with either the board composition statistical disclosure or the Diverse board member requirement of the proposed rule, the company will be notified that it has until the later of its next annual stockholders' meeting or 180 days from the time the deficiency occurred to provide a plan to regain compliance with the proposed rule or face potential delisting from Nasdaq. Nasdaq's proposed rule would generally apply to all companies listed on Nasdaq's U.S. exchange; however, certain companies are exempt from the proposed rule and certain companies, including Foreign Issuers[4] and Smaller Reporting Companies[5] as defined in the Securities Exchange Act of 1934, have certain modifications to the proposed rule that apply to them. In an attempt to assist companies in complying with Nasdaq's diversity rule, Nasdaq will provide companies with free access to a network of diverse, board-ready candidates, a tool to support board evaluation and refreshment, and a designated email address for companies and their counsel to pose questions to Nasdaq regarding application of the rule.

In Nasdaq's press release announcing its intent to file the proposed rule, Nasdaq identified a key goal of "provid[ing] stakeholders with a better understanding of the company's current board composition and enhanc[ing] investor confidence that all listed companies [on Nasdaq's U.S. exchange] are considering diversity in the context of selecting directors."[6] Proxy advisory firms, such as Glass Lewis or Institutional Shareholder Services ("ISS"), are among such stakeholders that will monitor the diversity of companies' boards. Notably, these firms have already begun to include certain diversity benchmarks in how they will recommend stockholders vote in the election of directors. For example, Glass Lewis will, effective for stockholder meetings held after January 1, 2022, generally recommend against the nominating committee chair of a board that has fewer than two female directors and, beginning in 2021, will assess companies' disclosures regarding diversity.[7] Currently, ISS will generally recommend against the nominating committee chair or other relevant directors for boards that do not include a woman. Commencing with stockholder meetings held after February 1, 2022, ISS will generally recommend against the nominating committee chair or other relevant directors for boards that do not include at least one ethnic or racially diverse member.[8]

Nasdaq's proposal follows on the heels of at least 12 state legislatures, in addition to the U.S. Congress, that have enacted or are considering enacting legislation relating to board diversity.[9] The state-based board diversity requirements that have received the most attention are those enacted in California in September 2018,[10] which are focused on gender diversity, and September 2020,[11] which are focused on racial diversity and LGBTQ+ inclusion. These requirements are applicable to corporations with principal executive offices in California. California's statutory board diversity requirements are substantially similar to Nasdaq's proposal in that both effectively require affected companies (i) to make certain disclosures regarding the diversity of their boards of directors, and (ii) to have at least one director who self-identifies as a woman in addition to at least one director who self-identifies as an underrepresented minority (with the Nasdaq proposed rule and the California statute both including racial/ethnic minorities and those who identify as LGBTQ+[12]). California's statute, however, provides for a proportionate structure to the mandated minimum amount of diverse directors, requiring an increased minimum number of directors who identify as a woman, as well as an increased minimum number of directors who identify as an underrepresented minority, based on the size of the corporation's board of directors.[13] Additionally, California's statute is more rigorous than Nasdaq's proposed rule in that it mandates compliance with its board diversity requirements (and imposes penalties for non-compliance with the mandates), while Nasdaq's proposed rule is structured as a "comply or explain" rule. Nasdaq acknowledged that it considered adopting a mandatory regime, but ultimately determined the "comply or explain" model would encourage companies to take action while providing them sufficient flexibility to maintain decision-making authority over their board's composition. Nevertheless, companies that fail to comply with Nasdaq's "comply or explain" rule are subject to delisting from Nasdaq's U.S. exchange.

In light of Nasdaq's proposed rule and similar legislative initiatives, as well as the trend toward increased diversity and inclusion in corporate boardrooms and research on the effects of diversity on governance, corporations and their boards should continue to evaluate the diversity of their current boards of directors on an ongoing basis.

See Nasdaq's proposed rule regarding diversity requirements here.

Footnots

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[1] *See* Nasdaq Proposed Rule 5606 (Board Diversity Disclosure).

[2] *See* Nasdaq Proposed Rule 5605(f)(2) (Board Diversity Representation).

[3] Companies listed on The Nasdaq Capital Market will be given five calendar years following SEC approval of the proposed rule to have two Diverse directors.

[4] 17 CFR § 240.3b-4.

[5] 17 CFR § 240.12b-2.

[6] Press Release, Nasdaq, Nasdaq to Advance Diversity Through New Proposed Listing Requirements, https://www.nasdaq.com/press-release/nasdaq-to-advance-diversity-through-new-proposed-listing-requirements-2020-12-01.

[7] *An Overview of the Glass Lewis Approach to Proxy Advice*, Glass Lewis, https://www.glasslewis.com/wp-content/uploads/2020/11/US-Voting-Guidelines-GL.pdf?hsCtaTracking=7c712e31-24fb-4a3a-b396-9e8568fa0685%7C86255695-f1f4-47cb-8dc0-e919a9a5cf5b.

[8] *Proxy Voting Guidelines Benchmark Policy Recommendations*, Institutional S'holder Servs. (Nov. 19, 2020), https://www.issgovernance.com/file/policy/latest/americas/US-Voting-Guidelines.pdf.

[9] Michael Hatcher & Weldon Latham, *States are Leading the Charge to Corporate Boards: Diversify!*, Harvard Law Sch. Forum on Corp. Governance (May 12, 2020), https://corpgov.law.harvard.edu/2020/05/12/states-are-leading-the-charge-to-corporate-boards-diversify/#:~:text=In%20September%202018%2C%20California%20Governor,executive%20office%E2%80%9D%20in%20the%20state.

[10] Cal. Corp. Code § 301.3.

[11] Cal. Corp. Code § 301.4.

[12] Nasdaq's proposed rule goes slightly further in its definition of LGBTQ+ by expanding it to include those in the queer community, while California's statute is limited to those identifying as gay, lesbian, bisexual, or transgender.

[13] If the corporation has at least five directors, the board must be comprised of at least two women and two underrepresented minorities. The board must be comprised of one additional director who identifies as a woman when the board consists of six or more directors, and the board must be comprised of one additional director who identifies as an underrepresented minority when the board consists of nine or more directors.

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