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PERSPECTIVE

Fifth Circuit renews controversy over Nasdaq board diversity initiative

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The Feb. 19 decision by the U.S. Court of Appeals for the 5th Circuit granting en banc review of the Nasdaq board diversity initiative was just the latest salvo in the ongoing series of challenges to efforts to diversify corporate boards. The full 5th Circuit will review Nasdaq's rule after vacating an earlier decision by a panel of Democratic appointees upholding the rule, which requires Nasdaq-listed companies to disclose information about the diversity (or lack thereof) of their directors, against constitutional and statutory challenges. Meanwhile, California's two board diversity laws, which require publicly traded companies headquartered in California to have a minimum number of diverse directors, remain on hold. In 2022, California Superior Court judges ruled that the laws violate the California Constitution and, even if those decisions are reversed on appeal, the laws face federal constitutional challenges in federal court. The Nasdaq rule and California laws differ in a couple of important ways. Firstly, the Nasdaq rule does not require boards to have a minimum number of "diverse" directors (as do the California laws), but instead takes a "diversify or disclose" approach. Secondly, Nasdaq is a private entity, unlike the State of California. While both sets of initiatives have been subject to challenge, these distinctions may affect whether the initiatives survive.

Nasdaq's rule faces another hurdle

In 2021, the Securities and Exchange Commission (SEC) approved Nasdaq's rule, which requires Nasdaq-listed companies (1) to publicly disclose board-level diversity statistics; and (2) if the company's board does not have at least two diverse directors, to explain the reason for that lack of diversity. Release No. 34-92590, 86 Fed. Reg. 44, 424 (Aug. 12, 2021).

Following the SEC's approval, the Alliance for Fair Board Recruitment (AFBR), a nonprofit formed by conservative activist Edward Blum, and the National Center for Public Policy Research (NCPPR), a conservative think tank, filed petitions to vacate the Rule in *Alliance for Fair Board Recruitment v. Securities and Exchange Commission*, No. 21-60626 (5th Cir.). Blum was also behind the successful challenge to college affirmative action programs in *Students for Fair Admissions, Inc. v. President & Fellows of Harvard College*, 143 S. Ct. 2141 (2023).

Last year, a 5th Circuit panel denied the consolidated petitions challenging the SEC rule. *All. for Fair Bd. Recruitment v. SEC*, 85 F.4th 226 (5th Cir. 2023). The panel did not reach the merits of the challengers' claims that the rule violates the First and Fourteenth

Amendments to the U.S. Constitution by compelling speech in a non-viewpoint-neutral manner and encouraging discrimination. Instead, the panel held that there was no state action, as would be necessary to subject the Rule to constitutional scrutiny. The panel reasoned that Nasdaq, a private entity, does not perform a traditional, exclusively public function, and the SEC's approval order did not constitute sufficient governmental entwinement to constitute state action.

The challengers sought rehearing en banc, with one citing *Students for Fair Admissions* as further support for its argument.

On Feb. 19, 2024, the 5th Circuit granted rehearing en banc, tentatively setting the case to be heard in May 2024. Nasdaq's rule remains in effect pending a decision by the en banc court.

California's board diversity laws still face several barriers

In 2018 and 2020, California enacted Senate Bill 826 and Assembly Bill 979 to require publicly traded companies headquartered in California to include on their boards a minimum number of female directors (Senate Bill 826) and directors from "underrepresented communities," which includes racial minority communities and the LGBTQ+ community (Assembly Bill 979). *See* Cal. Corp. Code §§ 301.3, 301.4. But California continues to be enjoined from enforcing the laws' minimum board diversity requirements for the foreseeable future.

In 2022, in separate cases, each titled *Crest v. Padilla*, two Los Angeles County Superior Court judges struck down the laws on the ground that they violate the state equal protection clause. The judges held that the laws fail to satisfy "strict scrutiny," which generally requires laws that classify individuals on the basis of protected characteristics to be narrowly tailored to achieve a compelling state interest. *See Crest v. Padilla,* 2022 WL 1565613 (Cal. Super Ct. May 13, 2022); *Crest v. Padilla*, 2022 WL 1073294 (Cal. Super Ct. Apr. 1, 2022). The cases are now before the California Court of Appeal, which has stayed its proceedings pending the California Supreme Court's decision in another case that raises questions about whether taxpayers have standing to sue the state government. *Padilla v. Crest*, No. B322276 (Cal. Ct. App.); *Padilla v. Crest,* No. B321726 (Cal. Ct. App.).

Meanwhile, in a federal case brought by AFBR, the U.S. District Court for the Eastern District of California independently struck down Assembly Bill 979, reasoning that it is a "racial quota" that violates the federal Equal Protection Clause. All. For Fair Bd. *Recruitment v. Weber*, 2023 WL 3481146 (E.D. Cal. May 15, 2023). However, the same court denied a federal equal protection challenge to Senate Bill 826, concluding that the law likely survives intermediate scrutiny because it is substantially related to the government's important interest in remedying past sex discrimination in corporate board selection processes. *Meland v. Weber*, 2021 WL 6118651 (E.D. Cal. Dec. 27, 2021). Notably, in state court, California has argued that Senate Bill 826 should similarly be subject only to intermediate scrutiny under the state constitution because the law was designed to remedy discrimination. These federal cases are now before the 9th Circuit U.S. Court of Appeals, which has stayed its proceedings in deference to the state cases. *See All. for Fair Bd. Recruitment v. Weber*, Nos. 23-15900, 23-15901 (9th Cir.); Nat'l Ctr. for *Pub. Pol'y Rsch. v. Weber*, No. 22-15822 (9th Cir.); *Meland v. Weber*, No. 22-15149 (9th Cir.).

Corporate governance lawyers, nominating and governance committees and corporate regulators will be watching these cases closely, with a careful eye on whether the differences between these approaches to board diversity (compelling diversity versus requiring disclosure of lack of diversity) and state versus private entity action, will affect the outcomes.

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