Securities Regulation Daily Wrap Up, DIRECTORS AND OFFICERS—Republican Senate banking members urge SEC to block Nasdaq's proposed board diversity quotas, (Feb. 12, 2021)

Securities Regulation Daily Wrap Up

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According to their letter, the lawmakers do not think Nasdaq should be using its quasi-regulatory authority to impose social policies.

In a February 12, 2021 letter to Acting SEC Chair Allison Herren Lee, Senate Banking Committee Ranking Member Pat Toomey (R-Pa.) and all Republican members of the committee urged the Commission to reject a proposed rule from Nasdaq that would require publicly traded corporations to adopt new racial and gender diversity standards for boards of directors. The request from the exchange would have the SEC approve a comply-or-explain rule change that would push listed companies to have at least two diverse directors on the board.

According to the letter, requiring diversity interferes with a board's duty to follow its legal obligations to govern in the best interest of the corporation and its shareholders. It also violates central principles of materiality that govern securities disclosures, and harms economic growth by imposing costs on public corporations and discouraging private corporations from going public. Nasdaq's "narrow concept" of mandated diversity, one that prioritizes race, gender, and sexual orientation, and pressured board diversity, misses the mark, the senators say.

The letter addresses several specific points.

The proposal runs contrary to a corporation's duty. According to the letter, Nasdaq's proposal interferes with the duty of a corporation to act in the best interest of its shareholders. The proposed rule would obstruct the "free and open market," that Nasdaq's proposal must be consistent with under Section 6(b)(5) of the Exchange Act, the senators claim and, further, its "arbitrary diversity" requirement does not demonstrably improve corporate performance and could sometimes harm it.

The letter authors also say that the research underpinning Nasdaq's proposal is incomplete. For example, the proposal does not sufficiently address the research results finding that gender board diversity correlates very little, if at all, with corporate performance. The senators also point out that corporations already want diversity among board members that could improve their operations. Also, Nasdaq's definition of diversity focuses on minority and gender status while giving short shrift to other types of diversity that could correlate with superior corporate performance. Finally, the senators find that the relationship between Nasdaq's proposed rule and Nasdaq's promotion of a board recruiting solution for diverse board candidates is unclear.

The proposal violates the concept of materiality. Nasdaq's proposal violates the concept of materiality because the disclosures would not help a reasonable investor evaluate a company's performance, the senators claim. The materiality doctrine prevents the development of an unstable, politicized securities regime that would be ripe for abuse of power. According to the senators, Nasdaq appears to be motivated by an "inappropriate desire" to influence social policy. Finally, Nasdaq's reliance on self-identification for board diversity disclosures poses liability concerns under the antifraud and reporting provisions of the federal securities laws, according to the letter. For example, under the proposal, federal securities laws could hold issuers, as the makers of false statements, liable for reporting board members' diversity information if their ethnic or gender identity is misrepresented.

The proposal would harm economic growth. According to the letter, Nasdaq's proposal, with the precedent set by approving it, would harm economic growth by introducing "unnecessary" regulatory costs, thus decreasing the attractiveness of U.S. capital markets and presenting an additional concern for corporations deciding to go and stay public. Among other things, compelling corporate behavior could harm economic growth if the resulting changes reduce board effectiveness and harm corporate performance, the senators say.

The senators are also concerned that Nasdaq has not undertaken a serious effort to quantify their proposal's costs and benefits. Cost benefit analysis is a hallmark of good regulatory governance, and Nasdaq's scant analysis is no substitute for the analysis needed for the SEC to evaluate this proposed rule, they claim.

According to a release, ranking member Toomey commented on the proposal in December 2020, saying:

"A quasi-regulatory body like Nasdaq should not be creating and enforcing social policy in America. This is the realm of democratically-elected representatives who are accountable to the public. As Berkshire Hathaway CEO and Democrat Warren Buffett has said, corporate board members should be chosen by merit–not quotas. The responsibility of a corporate board is to oversee management and govern in the best interests of the people who hire them—shareholders. America's corporate boardrooms are not the place for social engineering. Ultimately, these kinds of initiatives decrease the number of companies going public, reduce access to capital, and slow economic growth, which means fewer jobs and missed opportunities for retail investors."

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