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Diversity and Disclosure in the Boardroom: SEC Approves Nasdaq Board Diversity Rules

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On August 6, 2021, the U.S. Securities and Exchange Commission (*"SEC"*) approved rule changes proposed by The Nasdaq Stock Market LLC (*"Nasdaq")* requiring companies listed on its exchange to comply with certain disclosure requirements in order to enhance Board diversity and transparency.[1]

In essence, the "comply or disclose" nature of the rules (*"Board Diversity Rules"*) requires each Nasdaq-listed company to (i) have at least two Diverse directors (as further described below) or explain why it does not, and (ii) disclose information on the voluntary self-identified gender and racial characteristics and LGBTQ+ status of its Board, each of which is subject to certain exceptions. In addition, as described in more detail below, there are specified transition periods for compliance, based on the company's Nasdaq listing tier.

The Board Diversity Rules are intended to implement disclosure requirements around Board composition and to create a comprehensible and comparable matrix among Nasdaq-listed companies. The following provides an overview of the Board Diversity Rules and the framework for compliance.

Key Requirements:

As noted above, the Board Diversity Rules require companies to either have at least two self-identified "Diverse" members on their Board or to explain why they do not. At least one director must self-identify as Female and at least one director must self-identify as either an Underrepresented Minority and/or LGBTQ+. Notably, the Board Diversity Rules do not effectuate a Board diversity mandate. Rather, the Board Diversity Rules enhance transparency by establishing a disclosure framework. If a Nasdaq-listed company does not satisfy these diversity objectives, it must provide an explanation in either (i) a proxy statement (or if the company does not file a proxy statement, in its Form 10-K or 20-F) or (ii) on its website, submitted concurrently with its proxy statement (or Form 10-K or 20-F, as applicable), and send notice to the SEC one business day after posting (such disclosure, a *"Disclosure Statement").* Should a company explain why it does not meet the diversity objectives under the Board Diversity Rules, Nasdaq will not evaluate the merit or substance of such explanation. The explanation depends on a company's particular facts and circumstances and reasons will vary.

The rules have defined "Diverse" as a director who self-identifies as (i) female, without regard to the individual's designated sex at birth ("*Female*"), (ii) one or more of: 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 ("*Underrepresented Minority*"), and (iii) lesbian, gay, bisexual, transgender or a member of the queer community ("*LGBTQ+*").

With respect to the disclosure portion of the Board Diversity Rules, companies are required to annually report aggregated statistical information about its Board members' self-identified gender and racial characteristics and

[1] A short primer of the Nasdaq rules can be found here, and the SEC's amendment to those rules can be found here.

self-identification as LGBTQ+ using the provided matrix or a substantially similar format.[2] This disclosure must be made in a searchable format in an applicable Disclosure Statement.

Special Accommodations:

Certain kinds of entities will have more flexibility in meeting the diversity objectives of the Board Diversity Rules.

Smaller Reporting Companies:

Companies that have (i) a public float of less than $250 million or (ii) less than $100 million in annual revenues and either (x) no public float or (y) a public float of less than $700 million, are defined as "Smaller Reporting Companies" by SEC rules.[3] These companies cannot be investment companies, asset-backed issuers or a majority-owned subsidiary of a parent that is not a Smaller Reporting Company.

Instead of the two Diverse directors objective set forth in the Board Diversity Rules, consisting of both one Female and either one Underrepresented Minority or LGBTQ+ community member, Smaller Reporting Companies can satisfy this objective by having two Diverse directors, consisting of at least one Female director. In other words, the second Diverse director may include a director who self-identifies as one or more of the following: Female, LGBTQ+ or an Underrepresented Minority.

If a company is no longer considered a Smaller Reporting Company, then such company would have until the later of (i) one year from the date that it no longer qualifies as a Smaller Reporting Company or (ii) the date that it files its Disclosure Statement for the first annual meeting of shareholders subsequent to such event, to satisfy the diversity objective or otherwise explain why it does not.

Foreign Issuers:

Each Foreign Issuer with a Board of more than five members must have, or explain why it does not have, at least two Diverse directors, including at least one Female; however, similar to Smaller Reporting Companies, Foreign Issuers will have the added flexibility of being able to meet the objective by having either (i) two Female directors, or (ii) one Female director and one director who identifies as either an Underrepresented Minority or LGBTQ+. As with other entities, Foreign Issuers can alternatively satisfy the Board Diversity Rules by publicly explaining their reasons for not meeting the diversity objectives.

"Foreign Issues" are characterized as (i) a Foreign Private Issuer (as defined in Nasdaq Rule 5005(a)(19)) or (ii) a company that: (a) is considered a "foreign issuer" under Rule 3b-4(b) under the Securities Exchange Act of 1934[4] and (b) has its principal executive offices located outside of the United States.

Should a company cease to be considered a Foreign Issuer, it will have until the later of (i) one year from the date it no longer qualifies as a Foreign Issuer or (ii) the date it files its Disclosure Statement for the first annual meeting of shareholders subsequent to such event, to satisfy the diversity objective or otherwise explain why it does not.

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[2] The diversity matrix included in the final Board Diversity Rules is available at the Nasdaq Listing Center.
[3] 17 C.F.R. § 240.12b-2.
[4] The Securities Exchange Act of 1934 defines "Foreign Issuer" as any issuer which is a foreign government, a national of any foreign country or a corporation or other organization incorporated or organized under the laws of any foreign country."

Smaller Board Companies:

Companies with five or less directors on their board ("Smaller Board Companies") are only required to have one member of its Board who is Diverse. Additionally, if such a company has five members on its Board prior to becoming subject to the Board Diversity Rules, then it can add an additional sixth director who is Diverse in order to meet this objective, without falling out of the "Smaller Board Companies" category and subsequently needing to meet the original two Diverse director objectives. If, however, such a company increases the directors on its Board to more than six, then it will be subject to the full requirement of the Board Diversity Rules.

Exempt Entities:

Certain entities are exempt from having to comply with the requirements set forth in the Board Diversity Rules. Those entities include: (i) acquisition companies (SPACs); (ii) asset-backed issuers and other passive issuers; (iii) cooperatives; (iv) limited partnerships; (v) management investment companies; (vi) issuers of non-voting preferred securities, debt securities, and derivative securities that do not have equity securities listed on Nasdaq; and (vii) issuers of securities listed under the Nasdaq Rule 5700 series.

Note that while business development companies are management investment companies, they are not considered exempt entities, and are subject to the rules. Such companies are carved out of the definition of management investment companies and must comply with the Board Diversity Rules in full.

Transition Periods:

Other than newly listed companies (which will be subject to the Phase-In Periods discussed below), Nasdaq-listed companies must have:

- *At least one Diverse director* (or submit a Disclosure Statement of why they do not) by the later of (i) August 7, 2023 or (ii) the date the company files its Disclosure Statement for the company's annual 2023 shareholder meeting.

- *At least two Diverse directors* (or submit a Disclosure Statement of why they do not):

    - if listed on the Nasdaq Global Select Market or Nasdaq Global Market, by the later of (i) August 6, 2025 or (ii) the date the company files its Disclosure Statement for the company's annual 2025 shareholder meeting.

    - if listed on the Nasdaq Capital Market, by the later of (i) August 6, 2026 or (ii) the date the company files its Disclosure Statement for the company's annual 2026 shareholder meeting.

Further, such companies must also initially comply with the matrix disclosure portion of the Board Diversity Rules by one of the following applicable timeframes:

- if the company files its Disclosure Statement for 2022 before August 8, 2022 and does not include the required matrix therein, then by August 8, 2022;
- if the company files its Disclosure Statement for 2022 on or after August 8, 2022, then within one business day of filing such a statement; or
- if the company does not intend to file a Disclosure Statement for 2022, then by August 8, 2022, which should be posted on its website.

Additionally, Smaller Board Companies, regardless of where they are listed, must comply (or submit a Disclosure Statement of why they have not complied) with the applicable rules by August 7, 2023.

Phase-In Periods for Newly Listed Companies:

Newly listed companies that were not otherwise previously subject to a substantially similar requirement of another national securities exchange must have:

- *At least one Diverse director* (or submit a Disclosure Statement of why they do not):
    - if listed on the Nasdaq Global Select Market or Nasdaq Global Market, by the later of (i) one year from the listing date or (ii) the date the company files a Disclosure Statement for the company's first annual shareholder meeting after its listing.

Companies newly listed on the Nasdaq Capital Market do not have the one Diverse director phase-in and instead must only meet the two Diverse directors objective timeline noted below.

- *At least two Diverse directors* (or submit a Disclosure Statement of why they not):
    - if listed on the Nasdaq Global Select Market or Nasdaq Global Market, by the later of (i) two years from the listing date or (ii) the date the company files its Disclosure Statement for the company's second annual shareholder meeting after its listing.
    - if listed on the Nasdaq Capital Market, by the later of (i) two years from its listing date or (ii) the date the company files its Disclosure Statement for the company's second annual shareholder meeting after its listing.

Further, Smaller Board Companies, regardless of listing tier, must have (or submit a Disclosure Statement of why they do not have) at least one Diverse director by the later of (i) two years from the listing date or (ii) the date the company files its Disclosure Statement for the company's second annual shareholder meeting after its listing.

Additionally, newly listed companies must fully comply with the disclosure requirements of the Board Diversity Rules by publishing the statistical information as populated in the matrix noted in the section above within one year of its listing date.

Cure and Grace Periods:

The Board Diversity Rules provide for grace and cure periods for certain situations. If a Nasdaq-listed company does not comply with the diversity objectives and fails to provide the disclosure required or fails to hold an annual meeting of shareholders during the applicable periods set forth in the rules (circumventing the disclosure requirement), the Nasdaq Listing Qualifications Department will notify the company that it has until the later of (i) 180 days from the event that caused the deficiency or (ii) until its next annual shareholder meeting, to cure the deficiency either by meeting the diversity objectives or making the required Disclosure Statement.

The Board Diversity Rules provide further flexibility for a company that previously met the diversity objectives within the applicable timeframes but ceases to meet those objectives due to a Board vacancy. In such case, the company would have until the later of (i) one year from the date of the vacancy or (ii) the date it files its Disclosure Statement for its annual shareholder meeting in the calendar year after the year in which the vacancy occurs, in order to comply with the rules.

If the company still fails to meet the requirements after the cure period has lapsed, the Nasdaq Listing Qualifications Department will issue a Staff Delisting Determination Letter.

Key Takeaways:

The role of the Board has expanded over the years as directors have become more active advisors on areas regarding environmental, social and governance issues, such as climate change and racial and gender inequality. In its proposal, Nasdaq cited various studies that denoted a positive association between Board diversity, company performance, investor protections and decision making.[5] The Board Diversity Rules are consistent with similar measures by certain investors and advisors in the market to increase diversity and transparency in the leadership of the workplace. For example, Goldman Sachs implemented a recent requirement to have at least two diverse directors, including one woman, on the Boards of companies it helps take public after July 1, 2021.[6] JP Morgan Chase also has had a director advisory service since 2016, which places a priority of placing diverse candidates.[7]

While the newly adopted rules do not implement a Board diversity mandate on Nasdaq-listed companies, they do highlight the importance of diversity and inclusion considerations when selecting leadership and shareholders' increasing desire[8] for comparable metrics in this area. If a company does not meet the diversity guidelines set forth in the rules, it should carefully consider the attendant disclosure requirements and evaluate the potential shareholder and other stakeholder reaction to such disclosure.

For further information, please contact a member of the Haynes and Boone Capital Markets and Securities Practice Group.

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[5] Some of the studies cited are the following: (i) Jason M. Thomas and Megan Starr, The Carlyle Group, Global Insights: From Impact Investing to Investing for Impact 5 (Feb. 24, 2020), available at: https://www.carlyle.com/global-insights/invest-with-impact-whitepaper-thomas-starr, (ii) Bin Srinidhi et al., Female Directors and Earnings Quality, 28(5) Contemporary Accounting Research 1610, 1612-16 (Winter 2011), (iii) Ammar Gull et al., Beyond gender diversity: How specific attributes of female directors affect earnings management, 50(3) British Acct. Rev. 255 (Sept. 2017), available at: https://ideas.repec.org/a/eee/bracre/v50y2018i3p255-274.html, and (iv) International Monetary Fund, IMF Performance in the Run-Up to the Financial and Economic Crisis (August 2011), available at: https://www.elibrary.imf.org/view/books/017/11570-9781616350789-en/11570-9781616350789-en-book.xml.

[6] Goldman Sachs, *Board Diversity Initiative*, last visited August 15, 2021, at https://www.goldmansachs.com/our-commitments/diversity-and-inclusion/board-diversity/.

[7] J.P. Morgan, *Director Advisory Services*, last visited August 15, 2021, at https://www.jpmorgan.com/solutions/cib/investment-banking/director-advisory-services.

[8] Lorraine Woellert, Catherine Boudreau and Kellie Mejdrich, *Shareholders Target 'White Man's World' With Record Demands for Diversity Data*, Politico, published April 06, 2021, at https://www.politico.com/news/2021/04/06/shareholders-diversity-data-479159 (noting that shareholders have filed 69 proposals asking companies to disclose the diversity of their workforce and information on retention and promotions, which is twice the number filed in 2020).