CLIENT ALERT

SEC Approves Nasdaq "Comply or Explain" Diversity Requirements

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The Securities and Exchange Commission recently approved Nasdaq's proposed rules regarding board diversity.[1] Nasdaq's rules, initially proposed in December 2020, take a "comply or explain" approach, requiring most Nasdaq-listed companies to *either* (a) include on their boards of directors at least two "diverse" directors, or (b) explain why they do not meet these diversity benchmarks. The rules also will require Nasdaq-listed companies to disclose aggregate board diversity data.

Under the rules, each Nasdaq-listed company (subject to certain exemptions) will be required to have, or explain why it does not have, at least one director who self-identifies as female and one director who is either an "Underrepresented Minority" or is lesbian, gay, bisexual, transgender or queer ("LGBTQ+"). "Underrepresented Minority" is defined as "an individual who self-identifies as one or more of the following: 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."

If a company does not meet Nasdaq's applicable standard for board diversity, it will be required to disclose its failure to achieve this standard and the reasons why it was not able to do so. This disclosure must be made in advance of the company's next shareholder meeting in a proxy statement or on the company's website. Nasdaq has stated that it will not substantively evaluate companies' explanations of their failure to meet the standard.

1 See SEC Release No. 34-92590 (August 6, 2021), available here. The full text of Nasdaq's amended proposal, issued on February 26, 2021, including a summary of comments made on its initial proposal and Nasdaq's responses, is available here.

The new rules provide flexibility for certain issuers through the inclusion of exemptions and transition periods, some of which were added in response to comments to Nasdaq’s initial proposal. Companies with boards of directors of five or fewer members, companies that qualify as “smaller reporting companies” under Rule 12b-2 under the Securities Exchange Act and foreign issuers can meet the diversity standard with two female directors. Special purpose acquisition companies (“SPACs”), asset-backed issuers and certain other issuers will not be subject to the new rule’s diversity or disclosure requirements.

In addition to meeting Nasdaq’s board diversity standard or explaining why it has not met this standard, each Nasdaq-listed company (except for SPACs and other exempt issuers listed above) must disclose aggregate board diversity data in a specified matrix format. This disclosure must include data regarding the gender and race and ethnicity of directors and the number of directors who self-identify as LGBTQ+.

The new rules will go into effect in phases depending on the type of issuer. All Nasdaq-listed companies will be required will be required to have at least one diverse director (or explain why they do not) by August 7, 2023. Companies listed on the Nasdaq Global Select Market or Nasdaq Global Market will be required to fully satisfy the board diversity standard (or explain why they do not) by August 6, 2025; the deadline is extended an additional year until August 6, 2026 for companies listed on the Nasdaq Capital Market. All Nasdaq-listed companies will be required to disclose their aggregate board diversity data by August 8, 2022 or, if later, the date their next proxy statements are filed. Newly-listed companies will be given additional time to comply with both requirements.

Nasdaq’s rule is part of an increasing trend to encourage board diversity. For example, California enacted a law requiring public companies with their principal offices in California to have at least one board member who self-identifies as an underrepresented minority or as LGBTQ+. New York similarly requires corporations authorized to do business in the state to report the number of female directors on their boards. Nasdaq’s proposal and the SEC’s approval of it are emblematic of the investor community and regulators’ growing focus on diversity, inclusion and human capital management.

The SEC, meanwhile, is expected to propose its own rules regarding board diversity disclosures later this year, and its proposal may seek to impose even more significant requirements than Nasdaq. SEC Commissioners Allison Herren Lee and Caroline A. Crenshaw recently referred to Nasdaq’s rule as “a step forward for investors on board diversity,” and noted that “there is more work to be done in improving both diversity and transparency at public companies and in our capital markets more broadly.” These sentiments in response to the approval of Nasdaq’s proposal highlight the Commissioners’ expressed commitment to prioritizing environmental, social, and governance (“ESG”) issues under the SEC’s new leadership.

Notwithstanding the flexible “comply or explain” approach reflected in Nasdaq’s new rules, the rules, like other disclosure requirements, are intended to encourage companies to increase the diversity of their boards. We have already seen evidence of progress towards achieving this important goal. At the time it made its initial proposal in December 2020, Nasdaq stated that more than 75% of its listed companies would have fallen short of the requirements. In the past year, however, companies have made significant strides towards diversifying board representation. For example, according to a *Wall Street Journal* report, from June 2020 through May 2021, S&P 500 companies added 456 new independent directors, nearly 75% of whom are women or belong to a racial or ethnic minority. We expect this trend to continue, spurred not only by Nasdaq’s new rules and other forthcoming regulations, but also by growing investor and public scrutiny of board diversity and other ESG issues.

If you have any questions regarding this client alert, please contact the following attorneys or the Willkie attorney with whom you regularly work.

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