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En Banc Fifth Circuit Vacates SEC's Approval of Nasdaq Board Diversity Rules

On December 11, 2024, a narrowly split 9-8 *en banc* United States Court of Appeals for the Fifth Circuit vacated the approval of the Securities and Exchange Commission ("SEC") of three rules proposed by Nasdaq that would have required listed companies to disclose certain board diversity metrics and to have at least two "diverse" directors or to explain why the company does not. Diverging from a Fifth Circuit panel that had upheld the SEC's rule approval in October 2023, in *Alliance for Fair Board Recruitment* v. *SEC*, an *en banc* Fifth Circuit held that the SEC's approval of the proposed rules violated the Securities Exchange Act of 1934 (the "Exchange Act") and the Administrative Procedure Act ("APA").[1] The court held that the rules were not sufficiently related to the Exchange Act's purpose, as required under 15 U.S.C. § 78f(b), and therefore the SEC's approval of the rules was "arbitrary and capricious" under the APA.[2] *Alliance* marks yet another significant holding from the Fifth Circuit curtailing perceived SEC overreach.

Factual and Procedural Background

This case arises from the SEC's approval of three diversity disclosure rules proposed by Nasdaq (the "Proposed Rules"), an SEC-registered stock exchange that is a self-regulatory organization ("SRO").[3] Under the Exchange Act, SROs cannot amend their rules without SEC approval, which SROs can obtain by filing "a proposed rule change" with the SEC.[4] The SEC will approve the proposed rule "if—but only if—it finds" that the rule is "consistent" with Section 78f(b)'s requirements, which dictate that registered exchanges may only regulate matters "related to the purposes of [the Exchange Act] or the administration of the exchange."[5]

In 2020, in the wake of protests that brought "heightened attention" to the "diversity and inclusion" commitments of public companies, Nasdaq submitted three rules for SEC approval that were designed to promote "board diversity among its listed companies"—(1) Rule 5606 (the "Disclosure Rule"), which mandated the disclosure of statistics related to the "self-identified gender, [self-identified] race, and self-identification as LGBTQ+" of Nasdaq-listed companies' boards of directors; (2) Rule 5605(f) (the "Diversity Rule"), which required each Nasdaq-listed company "to have, or explain why it does not have," at least two directors who self-identify as "diverse," defined as one who "self-identifies as either female or an underrepresented racial or sexual minority"; and (3) Rule IM-5900-9 (the "Recruiting Rule"), which provided companies failing to meet the Diversity Rule's objectives with access to a "network of board-ready diverse candidates."[6]

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[1] *Alliance for Fair Board Recruitment* v. *SEC*, 2024 WL 5078034 (5th Cir. Dec. 11, 2024).
[2] *Id*. at *1.
[3] *Id*. (citing 15 U.S.C. § 78c(a)(26)).
[4] *Id.* (citing 15 U.S.C § 78s(b)(1)).
[5] *Id.* at *1–2.
[6] *Id*. at *1–3.

In August 2021, the SEC approved the Proposed Rules.[7] The SEC reasoned that the Disclosure and Diversity Rules were consistent with the Exchange Act's "core disclosure purpose," and that the Recruiting Rule would help companies meet the objectives proposed in the Diversity Rule.[8]

The Alliance for Fair Board Recruitment ("AFBR") and the National Center for Public Policy Research ("NCPPR") (collectively, "Petitioners") challenged the SEC's approval of the Proposed Rules on August 10, 2021 and October 5, 2021, respectively, directly in the Fifth and Third Circuit Courts of Appeal, as permitted by Section 25(a) of the Exchange Act.[9] The NCPPR's petition was subsequently transferred to the Fifth Circuit and consolidated with AFBR's proceeding.[10] Petitioners asserted that the SEC's approval of the Proposed Rules exceeded its statutory authority under the Exchange Act and the APA, and constituted state action that violated the First Amendment (by compelling controversial speech) and Fourteenth Amendment's Equal Protection Clause (by discriminating against non-diverse candidates) of the U.S. Constitution.[11]

The Fifth Circuit Panel's 2023 Decision

On October 18, 2023, a Fifth Circuit panel upheld the SEC's approval of the Proposed Rules. It found that Nasdaq was not a state actor subject to constitutional claims and that the SEC's approval of the Proposed Rules did not violate the Exchange Act or the APA.[12]

First, the Fifth Circuit rejected Petitioners' arguments that Nasdaq was a state actor and, as a result, did not address the merits of Petitioners' constitutional claims. The Fifth Circuit explained that Nasdaq is not a state actor simply because it is "heavily regulated by the SEC."[13]

Second, the Fifth Circuit held that the SEC's approval of the Proposed Rules did not exceed the agency's authority under the Exchange Act.[14] The Fifth Circuit explained that the plain language of the Exchange Act only requires the SEC to support its approval with relevant "substantial evidence," which the court reasoned it had done by "considering investors' subjective beliefs that disclosure" about board diversity would be "valuable."[15] The Fifth Circuit also found that the SEC met its burden under Section 78f(b)(5) of showing that the Proposed Rules were sufficiently related to the Exchange Act's "purposes" or the "administration of the exchange," given that the Act's "fundamental purpose" is to enhance "full disclosure in the securities industry."[16] In addition, the Fifth Circuit concluded that because the Proposed Rules did not impose a mandatory quota, they did not "interfere with the role of 'state corporate law.'"[17]

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[7] *Id*.; *Alliance for Fair Board Recruitment* v. *SEC*, 85 F.4th 226, 237–38 (5th Cir. 2023), *reh'g en banc granted, opinion vacated*, 2024 WL 670403 (5th Cir. Feb. 19, 2024), and *on reh'g en banc*, 2024 WL 5078034 (5th Cir. Dec. 11, 2024).
[8] *Alliance*, 2024 WL 5078034, at *5, *19.
[9] *Alliance*, 85 F.4th 226 at 239; *see also* Petition for Review, *Alliance for Fair Board Recruitment* v. *SEC*, No. 21-60626 (ECF No.1-1) (Aug. 10, 2021) (citing 15 U.S.C. § 78y(a)); Petition for Review and Motion for Transfer, *National Center for Public Policy Research* v. *SEC*, No. 21-60626 (ECF No. 48-2) (Oct. 5, 2021) (citing 15 U.S.C. § 78y(a)).
[10] *Alliance*, 85 F.4th 226 at 239.
[11] *Id*.; *see* Opening Brief for Petitioner AFBR, *Alliance for Fair Board Recruitment* v. *SEC*, No. 21-60626 (ECF No. 103) (Nov. 22, 2021); Opening Brief for Petitioner NCPPR, *Alliance for Fair Board Recruitment* v. *SEC*, No. 21-60626 (ECF No.113) (Dec. 20, 2021). AFBR did not challenge the Recruiting Rule.
[12] *Id*. at 236–66.
[13] *Id*. at 240 (citing *Manhattan Community Access Corp.* v. *Halleck*, 587 U.S. 802, 816 (2019)).
[14] *Id.* at 248.
[15] *Id*. at 248–49 (citing 15 U.S.C. § 78y(a)(4)).
[16] *Id.* at 256 (citing *Affiliated Ute Citizens of Utah* v. *United States*, 406 U.S. 128, 151 (1972); *Basic Inc.* v. *Levinson,* 485 U.S. 224, 230 (1988)).
[17] *Id.* at 255 (quoting *Business Roundtable* v. *SEC*, 905 F.2d 406, 411–12 (D.C. Cir. 1990)).

The court also found that the "major questions doctrine"—under which courts should, in "extraordinary cases" of "economic and political significance," "hesitate before concluding that Congress meant to confer . . . authority" for the relevant agency's action—did not apply.[18] The court explained that, here, the SEC's "asserted authority" was an "ordinary exercise of its power to approve exchange listing rules," and a "disclosure rule for board diversity information" was not "significant enough" to trigger the major questions doctrine.[19]

Third, the Fifth Circuit held that the SEC's approval of the Proposed Rules was not "arbitrary and capricious" in violation of the APA, because the SEC (1) conducted an independent review of the record; (2) properly assessed and concluded the that the Disclosure and Diversity Rules were designed to meet at least one of the Exchange Act's objectives, did not "permit unfair discrimination," and had associated costs that were "necessary or appropriate"; and (3) adequately assessed the Recruiting Rule.[20]

Motion for Rehearing

AFBR, on October 25, 2023, and NCPPR, on November 27, 2023, petitioned for rehearing *en banc* of their constitutional and statutory claims against the SEC, asserting that the Fifth Circuit panel erred by (1) misapplying Fifth Circuit and Supreme Court precedent to find that there was no state action and (2) concluding that the SEC's approval of non-material, disclosure-based rules with no relationship to corporate performance did not exceed its statutory authority under the Exchange Act or APA.[21] On February 19, 2024, the court granted Petitioners' request for rehearing *en banc*, thus vacating the original Panel's decision.[22]

The Fifth Circuit's *En Banc* Decision

Upon rehearing, the Fifth Circuit vacated the SEC's approval of the Proposed Rules, finding that (1) they were not sufficiently related to the purpose of the Exchange Act (and thus the SEC's approval thereof was "arbitrary and capricious" in violation of the APA) and (2) the major questions doctrine applied, which counseled the court to view the SEC's approval with skepticism.[23] The *en banc* Fifth Circuit did not address Petitioners' constitutional claims under the First or Fourteenth Amendments.

First, the *en banc* Fifth Circuit held that the Proposed Rules were not related to the Exchange Act's purpose, as required under Section 78f(b), which is to "prevent inequitable and unfair practices" and "stamp out 'excessive speculation'" in the securities market.[24] The SEC argued that the Proposed Rules related to that purpose by promoting "just and equitable principles of trade"; "remov[ing] impediments" to a "free and open market"; and protecting "investors and the public interest."[25] The *en banc* Fifth Circuit disagreed and explained that, while the "just

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[18] *Id*. at 256 (citing *West Virginia* v. *Environmental Protection Agency*, 597 U.S. 697, 721 (2022)).
[19] *Id*.
[20] *Id*. at 258–66.
[21] AFBR's Pet. For Reh'g *en banc*, *Alliance for Fair Board Recruitment* v. *SEC*, No. 21-60626, ECF No. 297 (5th Cir. Oct. 25, 2023); NCPPR's Pet. For Reh'g *en banc*, *Alliance for Fair Board Recruitment* v. *SEC*, No. 21-60626, ECF No. 299 (5th Cir. Nov. 27, 2023).
[22] *Alliance for Fair Board Recruitment* v. *SEC*, 2024 WL 670403, at *1 (5th Cir. Feb. 19, 2024).
[23] *Alliance*, 2024 WL 5078034, at *1. NCPPR's statutory challenge to the Recruiting Rule was denied as moot because Nasdaq's "authority to offer benefits" under the Rule had expired. *Id*. at *19. As such, references to the "Proposed Rules" in Section II of this memorandum concern the Diversity and Disclosure Rules exclusively.
[24] *Id*. at *7.
[25] *Alliance*, 2024 WL 5078034, at *11–15 (citing 15 U.S.C. § 78f(b)(5)).

and equitable" provision requires exchanges to promote "ethical behavior," the Proposed Rules were "far removed" from the provision's "ordinary applications," and the court was unaware of any rules or customs "of the securities trade" requiring board diversity.[26] Similarly, the court explained that the rules were not authorized by the "impediment removal" provision because they did not, for instance, "reduce the transaction costs" associated with the securities market.[27] The court also found that the rules were not authorized by the "public interest" provision, which protects the public from the "harms" that the Exchange Act was "explicitly" meant to address—"speculation, manipulation, fraud, [and] anticompetitive exchange behavior."[28] The SEC's approval of the Proposed Rules was thus "arbitrary" and "capricious" under the APA, given that the SEC failed to demonstrate that the Proposed Rules were "consistent with the requirements of the Exchange Act."[29]

Second, the *en banc* Fifth Circuit found that the major questions doctrine applied, which "counsel[ed]" the court to view the SEC's approval of the Proposed Rules with "skepticism."[30] The court explained that the SEC's approval (1) was of "staggering" economic and political significance, since Nasdaq is the second-largest stock exchange in the world and the Proposed Rules were responsive to and embodied a "politically divisive issue," (2) represented the exercise of a "novel" power, given that, since its establishment in 1934, the SEC had "never claimed the authority to impose diversity requirements, or anything resembling them," and (3) "intrude[d]" into the "domain of state law."[31]

The dissent—penned by Judge Stephen A. Higginson, who wrote the Fifth Circuit's 2023 decision before the case was reheard *en banc*—emphasized that the SEC has limited discretion to reject the proposed rules of an exchange such as Nasdaq.[32] The dissent explained that the SEC cannot "displace [the] business judgement" of SROs "with its own policy priorities."[33] In addition, the dissent criticized the majority for "overlook[ing] this limited SEC role, fixed by Congress," and replacing it with a "new, mandatory and enlarged role for SEC intervention."[34]

Conclusion

The Fifth Circuit's *en banc* decision in *Alliance* provides significant guidance on the extent of the SEC's discretion to approve exchange rules that touch on issues of corporate governance and social policy designed to promote board diversity. It also highlights the judiciary's increasing reliance on the major questions doctrine in cases involving challenges to regulatory decision-making.[35] *Alliance* leaves Nasdaq and other exchanges with uncertain pathways to

[26] *Id.* at *12.
[27] *Id*. at *13.
[28] *Id*.
[29] *Id.* at *19.
[30] *Id*. at *15–17.
[31] *Id*.
[32] *Id*. at *20 (Higginson, J., dissenting).
[33] *Id*. at *21 (Higginson, J., dissenting).
[34] *Id*. (Higginson, J., dissenting).

[35] *See West Virginia*, 597 U.S. at 723 (invoking the major questions doctrine in holding that the EPA did not have authority to set certain emission caps under the Clean Air Act); *Biden* v. *Nebraska*, 143 S. Ct. 2355, 2374 (2023) (invoking the major questions doctrine in holding that the Secretary of Education did not have the authority to grant partial forgiveness for federal student loans under the Higher Education Relief Opportunities for Students Act of 2003); *Texas* v. *Nuclear Regulatory Commission,* 78 F.4th 827, 844 (5th Cir. 2023) (invoking the major questions doctrine in declining to defer to the Nuclear Regulatory Commission's interpretation of the Atomic Energy Act), *cert. granted*, 2024 WL 4394124 (U.S. Oct. 4, 2024), *cert. granted sub nom*., *Interim Storage Partners, LLC* v. *Texas*, 2024 WL 4394130 (U.S. Oct. 4, 2024).

promote diversity initiatives and suggests that future efforts to regulate in this area may require explicit congressional action.

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