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To Have or Have Not: The Limits of Comply-or-Explain Governance in an American Exchange

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TO HAVE OR HAVE NOT: THE LIMITS OF COMPLY-OR-EXPLAIN GOVERNANCE IN AN AMERICAN EXCHANGE

ABSTRACT

In 2020, the National Association of Securities Dealers Automated Quotations (“Nasdaq”) proposed a comply-or-explain governance rule to the Securities and Exchange Commission (“SEC”), aimed at increasing diversity in companies listed on its exchange. The resulting listing rule—approved by the SEC in 2021—was met with a mixed chorus of cheers and jeers from the public and regulated companies. Missing from that chorus, however, was an analysis of the effectiveness of Nasdaq’s approach in using a flexible, predominantly international comply-or-explain governance model to regulate the companies listed on its exchange.

Framed as a disclosure code, Nasdaq’s Listing Rule 5605(f)(2) requires listed companies to either have at least two diverse board members or provide an explanation for why the company has failed to do so. Comply-or-explain governance represents an attempt by regulators to meet the needs of companies while also nudging companies in the direction of a best practice—which in Nasdaq’s case is to have two diverse board members. Widely used in Europe, the governance approach toes the line between mandating compliance and allowing companies to adjust the code to their needs. However, inherent in the flexibility allowed for by comply-or-explain governance comes certain flaws prevalent in international jurisdictions that can result in minimal adoption and consequently minimal change.

This Comment assesses Nasdaq’s Listing Rule 5605(f)(2) for its likely impact in boardrooms of the more than 3,000 companies listed on its exchange, highlighting critical gaps that could result in the aspirational code. This Comment then proposes a solution to the Rule to fill the gaps through increased Nasdaq monitoring and publication without overextending the exchange beyond its constitutional or statutory limits.
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INTRODUCTION

In the last five years, America has experienced sweeping social change. In the wake of the past two elections and the killing of George Floyd, many American citizens reevaluated their understanding of American institutions. One such institution that has been widely brought under scrutiny is the corporation. An obvious and immediate area of the corporation that regulators have looked to is the boardroom. While some business leaders have tried to redefine corporate objectives to better align with the changing social climate, many experts see corporate boardroom composition as an immediate area for change given directors’ integral role in corporations. As this Comment later explains, though corporate board diversity has seen some progress, diverse directors still make up a small percentage of directors in corporations.

In recent years, U.S. states have tried to mandate the inclusion of diverse directors or require disclosure of the composition of corporate boards to bridge the gap. While some of these state enactments face growing opposition through...

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2 See id. (explaining that millions of people protested during the Black Lives Matter demonstrations in 2020 and the Women’s March in 2017).
5 See Statement on the Purpose of a Corporation, BUS. ROUNDTABLE, https://opportunity.businessroundtable.org/ourcommitment/ (last visited Jan. 29, 2023). But see Singh, supra note 4 (“[D]iversifying boards . . . steer[] companies in the right direction, but they are not enough to diversify static and often homogeneous board environments.”).
7 For example, the California bill, State Assemb. 979, 2020 Leg. (Cal. 2020), requires a minimum number of corporate directors to be from underrepresented communities depending on the size of the corporation’s board and S. 826, 2018 Leg. (Cal. 2018), requires publicly held corporations in California to have a minimum number of female directors based on the size of the board. Under both California’s Assembly Bill 979 and Senate Bill 826, a California-headquartered company that did not comply with the gender and diversity board quotas would have to pay a fine of $100,000 for its first violation and $300,000 for each violation thereafter. Sarah Fortt, Betty
litigation, having even been struck down as unconstitutional, other non-governmental regulatory entities have enacted their own rules to increase corporate board diversity. As a Self-Regulatory Organization (“SRO”) subject to the requirements of the Securities Exchange Act of 1934 (“1934 Exchange Act”), the National Association of Securities Dealers Automated Quotations Stock Market LLC (“Nasdaq”) filed a proposal to amend its listing rules with the Securities and Exchange Commission (“SEC”) in December of 2020. Using a comply-or-explain governance model, Nasdaq’s Listing-Rule 5605(f)(2) requires Nasdaq-listed companies to either have at least two diverse directors or to explain why they do not (also known in this Comment as the “Diversity Inclusion Rule”). The two diverse directors must include at least one female and at least one other underrepresented minority or LGBTQ+ individual. In tandem with the Diversity Inclusion Rule, Nasdaq also proposed Listing-Rule 5606, which requires listed companies to publish statistical information on the diversity make up of their board (also known in this Comment as the “Diversity Matrix Rule”). On August 6, 2021, the SEC approved Nasdaq’s Diversity Inclusion Rule and Diversity Matrix Rule, finding the rules consistent with the requirements of the 1934 Exchange Act.

This Comment examines Nasdaq’s newly adopted listing rules, specifically the Diversity Inclusion Rule, and its potential for implementing meaningful change in the composition of Nasdaq-listed corporate boards. In doing so, this

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8 See Fortt et al., supra note 7.
12 See id. at 80472 (“[R]equire Nasdaq-listed companies . . . (A) to have at least one director who self-identifies as a female, and (B) to have at least one director who self-identifies as Black or African American, Hispanic or Latinx, Asian, Native American or Alaska Native, Native Hawaiian or Pacific Islander, two or more races or ethnicities, or as LGBTQ+, or (C) to explain why the company does not have at least two directors on its board who self-identify in the categories listed above[,]”).
13 See id. Under the Rule, an underrepresented minority is defined as someone who identifies as “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.” Id. at 80473.
14 Id.
15 Id.
16 Id.
Comment will examine the different arguments for and against a comply-or-explain approach in corporate governance codes. Mainly a European form of governance regulation, comply-or-explain codes are a voluntary form of accountability.\(^\text{17}\) As the name suggests, comply-or-explain codes are not mandates but instead allow a company to not “comply” with the code’s targeted practice by explaining why it has not done so.\(^\text{18}\) Often, like Nasdaq’s Diversity Inclusion Rule, comply-or-explain codes do not require extensive explanations for why the company has not adopted the target practice.\(^\text{19}\) Instead, markets should regulate the subjected companies, as current and prospective shareholders consider a company’s choice not to comply and its explanation for not doing so.\(^\text{20}\) Thus, comply-or-explain governance codes give shareholders “sufficient governance-related information to make informed choices on where to invest and how to vote their shares.”\(^\text{21}\)

This Comment argues: (a) while Nasdaq’s Diversity Inclusion Rule is an important step toward increasing boardroom diversity, the Rule suffers from gaps that will lead to minimal change; (b) only a rule that requires quality explanations of boardroom diversity—or the lack thereof—and gives material information to all stakeholders can improve director diversity and markets; and (c) that Nasdaq should amend its rules to increase requirements for noncomplying explanations, expand monitoring and dialogue with regulated companies, and publish all disclosures under its newly adopted Rules 5605(f)(2) and 5606.

This Comment proceeds in four parts. Part I lays the foundation for why there is a need for increased board diversity in the United States. First, Part I explains the larger benefits of a diverse corporate board in increasing corporate diversity overall. Second, it examines the various competing studies on the effects of diversity on corporate boardrooms. Third, it provides the current statistics and trends in boardroom diversity with possible explanations for the minimal increase in board diversity to date.

Part II examines the current approach to board diversity inclusion in the United States and how Nasdaq’s diversity rules compare to that regulatory effort.

\(^{17}\) See Andrew Keay, Comply or Explain in Corporate Governance Codes: In Need of Greater Regulatory Oversight, 34 LEGAL STUD. 279, 279 (2014).

\(^{18}\) See id. at 280.

\(^{19}\) See id.


\(^{21}\) Id.
Part II first examines the SEC’s current regulatory approach to diversity, then it gives a fuller explanation of the reasoning and arguments for Nasdaq’s diversity rules.

Part III examines comply-or-explain governance models as a solution for increasing corporate boardroom diversity. It assesses both the benefits of comply-or-explain codes and the potential downfalls for implementing change when comply-or-explain codes are used for controversial standards and how such downfalls will apply to Nasdaq’s Diversity Inclusion Rule.

Finally, Part IV of this Comment considers a missing piece in Nasdaq’s Diversity Inclusion Rule that stems from its choice of the comply-or-explain approach: the public stakeholder. Also, it proposes that Nasdaq amend its listing rules to ensure meaningful change in the boardrooms of Nasdaq-listed companies.

I. THE HOMOGENOUS BOARD AND THE BENEFITS OF DIRECTOR DIVERSITY

The American corporate boardroom has largely looked the same for most of its existence; only recently has the institution begun to see change. This Part reviews the current understanding and data on diversity in corporate boardrooms. It first explains why the corporate boardroom is an important starting point to increase corporate diversity overall. Second, it examines whether a more diverse board benefits a corporation. Finally, it gives a deeper analysis of the current data on corporate boardroom diversity in the United States and the trends that have appeared in recent years.

A. The Corporate Boardroom as a Starting Point for Increased Diversity

In American corporate law, boardrooms play an integral role within the modern legal structure of the publicly traded corporation. For instance, Delaware law provides that “[t]he business and affairs of every corporation organized under this chapter shall be managed by or under the direction of a board of directors.” While directors delegate a corporation’s management to various officers, directors still perform essential functions in the corporation

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in addition to their monitoring and advising roles. Directors select senior officers of the corporation, including the CEO. After selecting corporate officers, directors set the officers’ compensation, thus controlling management incentives. Finally, directors make fundamental corporate decisions that can have larger ramifications beyond the corporation.

Given the influence and critical functions of a corporate board, increased board diversity is a starting point for expanded diversity throughout corporate America. First, research shows that diverse boards correlate with increased diversity in the broader corporate hierarchy through what is known as “spillover[].” For example, a twelve-year study of the S&P 1500 found that increases in the number of female directors at a company led to increases in the share of women in top management. Researchers attributed this finding to “gender spillovers from board members to executives.” In addition, it is suggested that similar effects may exist for underrepresented minorities who can similarly advocate for, hire, or promote other minorities after reaching the top of a corporate hierarchy.

Another reason scholars and economists identify diversity in the boardroom as an important step toward a more diverse corporate culture is “signaling theory.” From the notion of asymmetric information, signaling theory

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25 Bebchuk, supra note 22, at 679; DHIR, supra note 20, at 30.
26 DHIR, supra note 20, at 30.
27 Bebchuk, supra note 22, at 680.
28 See id. (explaining that major decisions—like responding to an acquisition offer—are made by the board).
29 David A. Matsa & Amalia R. Miller, Chipping Away at the Glass Ceiling: Gender Spillovers in Corporate Leadership, 101 AM. ECON. REV. 635, 638 (2011); DHIR, supra note 20, at 32.
31 Matsa & Miller, supra note 29, at 638.
32 See Devon W. Carbado & Mitu Gulati, Race to the Top of the Corporate Ladder: What Minorities Do When They Get There, 61 WASH. & LEE L. REV. 1645, 1692 (2004) (“[S]trong incentives exist for minorities to race to the top of the corporation and pull the ladder up behind them when they get there.”); cf. Te-Ping Chen, Why Are There Still So Few Black CEOs?, WALL ST. J. (Sept. 28, 2020, 10:16 AM), https://www.wsj.com/articles/why-are-there-still-so-few-black-ceos-11601302601 (stating that African Americans represent only 3% of executive or senior level roles among U.S. companies with 100 or more employees).
33 DHIR, supra note 20, at 33.
examines the nature of communication between a signal sender and a signal receiver, which here is the corporate board and the stakeholders.\textsuperscript{34} Signaling theory is a catalyst for increased corporate diversity because diverse boards send a signal to the employees and broader community that the corporation serves a “heterogeneous marketplace,” giving the corporation reputational capital and making it more likely for diverse job seekers to apply to work there.\textsuperscript{35} To many diverse job candidates, the signal of diversity at the top of a corporation’s hierarchy may eliminate fears of the informal networks that are viewed as barriers to such job seekers.\textsuperscript{36} For instance, diverse directors send “credible signals of the absence of a glass ceiling” within the organization.\textsuperscript{37} Therefore, through the signal of a diverse boardroom in tandem with the spillover effect, it follows that boardrooms can serve as a catalyst for broader diversity throughout corporations.

B. The Evidential Benefits of Having a Diverse Board

In addition to serving as a good starting point for broader corporate diversity, a diverse boardroom also has shown to have beneficial effects for corporations. In its Diversity Inclusion Rule and Diversity Matrix Rule proposal, Nasdaq cited a significant body of research on the impacts that diverse boardrooms have on three performance indicators: financial performance, investor protection, and corporate decision-making.\textsuperscript{38} This section examines that research and other studies on the effects of diverse boardrooms.

1. The Relationship Between Director Diversity and Financial Performance

For many years, researchers have studied the effects of diverse boardrooms on the financial performance of corporations, both domestically and abroad. Nasdaq cites several of these studies that find a correlation between diverse


\textsuperscript{35} See DiHR, supra note 20, at 33. \textit{But see} Broome & Krawiec, supra note 34, at 450 (arguing that female and minority directors are a “distant device through which to signal the asserted qualities of interest to signal recipients” due to the board’s separate position in a firm and the tendency for corporations to hire board members from outside the corporation).

\textsuperscript{36} See DiHR, supra note 20, at 49.

\textsuperscript{37} Broome & Krawiec, supra note 34, at 450; see Matsa & Miller, supra note 29, at 638 (“[T]here is evidence of gender spillovers from board members to executives.”).

directors and shareholder value. One such study found that observed companies with two or more diverse directors had average earnings grow 12.3% over three years, compared to 0.5% for companies without diverse directors. The same study found that “companies with diverse boards generate earnings growth that’s five times faster, on average, with each diverse board member associated with a 5% increase in annualized earnings growth.”41 In a 2020 study, researchers also found a “positive, statistically significant correlation between company financial outperformance and [board] diversity, on the dimensions of both gender and ethnicity.”42

Additional studies highlight the financial performance impacts of director diversity. For instance, a 2014 study examining companies over nine years found that companies with at least one female director had an average sector-adjusted return on equity of “12.2% compared to 10.1%” for companies without a female director.43 Similarly, in a 2016 study, U.S. companies with at least three female directors experienced median gains in earnings per share of 37% over five years, whereas companies without female directors experienced a median decrease of 8% in earnings per share.44 Moreover, Out Leadership, an organization that works to increase LGBTQ+ representation in corporate leadership, observed that the positive correlation between diversity and corporate performance are also applicable to LGBTQ+ diversity.45 Therefore, with several studies finding positive associations between boardroom diversity and earnings, diverse boardrooms can be beneficial beyond just increasing diversity in a corporation.

39 See id. at 80475 & n.21.
41 See THOMAS & STARR, supra note 40, at 5 & n.19 (defining diverse as female, Black, Hispanic, or Asian).
2. *The Relationship Between Board Diversity and Investor Protection*

The relationship between board diversity and investor protection is another important indicator of the benefits of a diverse boardroom. Many studies have found that increasing diverse directors leads to investor protection. One such study found that female directors are more likely to sit on the audit committee of their corporation, which, importantly, is associated with improved financial reporting discipline, leading to increased investor confidence in financial statements. For instance, research examining companies listed on the Madrid Stock Exchange from 2004–2011 found that gender-diverse audit committees improved the quality of financial information. Furthermore, gender-diverse audit committees increase investor protection by reducing the likelihood of error-based qualifications, noncompliance, or incomplete information and ensuring that corporate officers “do not seek to pressure auditors into issuing a clean opinion instead of a qualified opinion” when uncertainties arise.

Outside of the audit committee, another study concluded that gender-diverse boards are associated with lower rates of financial reporting errors and fraud. Moreover, direct evidence found that diverse boards are more likely to hold CEOs and other executives accountable, further reducing the chances of fraud. Thus, in uncertain economic times, as is true at the time of this Comment, investor protection is more important than ever and another reason that diverse boards benefit corporations.

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50 Id. at 363, 368.
51 Aida Sijamic Wahid, *The Effects and the Mechanisms of Board Gender Diversity: Evidence from Financial Manipulation*, 159 J. BUS. ETHICS 705, 721 (2018) (finding that companies with female directors have “fewer irregularity-type restatements, which tend to be indicative of financial manipulation”); see also Douglas J. Cumming, T.Y. Leung & Oliver Rui, *Gender Diversity and Securities Fraud*, 58 ACAD. MGMT. J. 1572, 1588 (2015) (citing other studies that suggest that “other forms of board of director diversity . . . may likewise reduce fraud”).
52 See Adams & Ferreira, supra note 47, at 292.
3. The Relationship Between Diversity and Board Decision-Making

A final indicator researchers have identified for the benefits of diverse boardrooms is its impact on board decision-making, particularly its reducing of “groupthink.” Groupthink is defined as “a dysfunctional mode of group decision making characterized by a reduction in independent critical thinking and a relentless striving for unanimity among members.” Heterogeneous groups, on the other hand, are more likely to have “conflicting opinions, knowledge, and perspectives,” and, thus, consider a wider scope of analyses, options, and concerns. These characteristics of heterogeneous groups are consistent in diversely composed boards, and the reduction in groupthink in diverse boardrooms is found to reduce stock return volatility as diverse boards influence financial decision-making through a wider array of perspectives.

Eliminating groupthink is especially significant given the gravity of a board’s role in a corporation. A board’s role today arguably expands beyond its essential functions. As Nasdaq writes in its initial proposal, “boards are now more active, frequent advisors on areas such as cybersecurity, social media, and environmental, social and governance . . . issues such as climate change and racial and gender inequality.” Therefore, the decisions boards make can affect the lives of more people than just shareholders. Thus, incorporating diverse viewpoints into the boardroom is more relevant than ever as corporate America navigates today’s changing social climate.

4. Lack of Causation Should Not Prevent Diversity

As explained in the preceding paragraphs, boardroom diversity is positively associated with increased financial performance, more rigorous investor protection, and improved decision-making. However, as some critics of Nasdaq’s newly adopted listing rules have remarked, many boardroom-diversity
studies have only found a correlation and not causation. While these critics have used this weakness in the studies to argue against boardroom diversity initiatives, that these studies lack causality should not determine any regulatory response. For instance, better firm performance may lead to increased board diversity rather than the reverse, as firms with greater financial resources have room to dedicate themselves to diversity initiatives. Also, empirical studies have been unable to establish a direct relationship between financial performance and other aspects of board composition; thus, it follows that the same would be true for diversity. Furthermore, scholars have argued that it is possible there are not enough diverse directors to “show consistent positive impact in empirical studies.”

However, a benefit of boardroom diversity largely missing from the existing research and worth considering in this context is the increase in reputational capital. As explained before, diverse boardrooms send signals to the market. In today’s social climate, if a company is seen as failing in Environmental, Social, and Governance (“ESG”) categories such as diversity, it can drastically hurt its stock performance. On the other hand, a company that is seen as succeeding in ESG categories can see positive impacts in the attractiveness of its stock, goods, and services. For instance, one study found that ESG performance and disclosure help companies build reputational capital after going public, which increases stock value without excessive volatility or

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62 See id. at 392. Specifically, studies showing that independent directors are associated with improved corporate functioning is much less questioned than diversity. Id.


64 See supra notes 34–37 and accompanying text.


66 Olivia Valentine, The Growing Importance of Brand Responses to Equality and Diversity, WE ARE SOCIAL (July 30, 2020), https://wearesocial.com/blog/2020/07/thegrowing-importance-of-brand-responses-to-equality-and-diversity (showing that at least part of consumers’ purchasing decision comes from consideration of whether a brand aligns with their values); Damion Waymer & Sarah VanSlette, Corporate Reputation Management and Issues of Diversity, in THE HANDBOOK OF COMMUNICATION & CORPORATE REPUTATION 471, 473 (Craig E. Carroll ed., 2013) (noting that the benefits of a favorable reputation include the ability for corporations “to charge premium prices, attract better applicants, enhance their access to capital markets, and attract investors”).
downside risk.\textsuperscript{67} ESG success is also a tool in attracting top talent among younger workers.\textsuperscript{68} As stakeholder views of ESG continue to progress, evidence suggests that companies that fail to keep up can suffer.\textsuperscript{69} Therefore, while a lack of causal evidence exists in studies of board diversity and corporate performance, it should not prevent the integration of changing economic and social goals into modern corporations.

C. Current Trends in Board Diversity

Despite the benefits that corporations can reap from having a diverse representation on their boards, companies still struggle to achieve adequate levels of diversity.\textsuperscript{70} This section examines the state of diversity on corporate boards in America today, offering possible explanations for why boards look the way they do and why regulatory measures may be necessary in order to encourage and incentivize corporations to prioritize diversity in the boardroom.

1. The Current Composition of Corporate Boards

Current trends in board diversity are promising, but while many large players in corporate America call for increased board diversity, these efforts are not seeing substantial impacts.\textsuperscript{71} For instance, women have seen large gains in corporate boardrooms yet still make up a small percentage of total board seats in America. In 2020, women made up about 30\% of Fortune 500 board seats, a record high.\textsuperscript{72} However, women are still disproportionately underrepresented compared to their 50.2\% share of the U.S. population.\textsuperscript{73} According to a Government Accountability Office report, it could take up to the year 2064 for U.S. companies to achieve gender parity on their boards.\textsuperscript{74}


\textsuperscript{69} See, e.g., Garcia, supra note 65.


\textsuperscript{71} Id.

\textsuperscript{72} Women on Corporate Boards (Quick Take), CATALYST (Nov. 5, 2021), https://www.catalyst.org/research/women-on-corporate-boards/.

\textsuperscript{73} Chris Brunner & Leo E. Strine, Jr., \textit{Duty and Diversity}, 75 VAND. L. REV. 1, 12 (2022).

\textsuperscript{74} U.S. GOV'T ACCOUNTABILITY OFF., \textsc{Corporate Boards: Strategies to Address Representation of Women Include Federal Disclosure Requirements} 9 & fig.3 (2015), https://www.gao.gov/assets/gao-16-30.pdf.
On the other hand, the percentage of underrepresented minority directors in the United States remains low. Despite African Americans making up 13.4% of the population, as of 2020, African American directors made up only 8.6% of Fortune 500 board seats.\(^75\) Meanwhile, in 2020, minority women made up only 4.6% of Fortune 500 board seats,\(^76\) and, in 2018, fewer than twenty Fortune 500 directors self-identified as LGBTQ+.\(^77\) Such numbers are surprising considering white directors comprise 83.9% of all Fortune 500 company boards in 2020, 28% higher than their percentage of the U.S. population.\(^78\)

While there has been some progress in increasing gender diversity on corporate boards in recent years, underrepresented minorities have made relatively minimal gains in obtaining board seats. However, a changing social climate may not be enough to spur corporations into abandoning their traditional director recruiting due to the persisting obstacles minorities face in climbing corporate hierarchies. The next subsection explores the obstacles that minority director candidates face and suggests regulation is needed to guarantee representative boardrooms in America’s largest corporations.

2. Possible Explanations for the Current Composition

The current composition of corporate boardrooms in the United States is likely due to a long list of influences beyond the scope of this Comment; however, two key areas are worth mentioning. First, bias studies have found that a candidate’s ability to get a leadership position is partly contingent on their leadership competencies.\(^79\) However, a candidate’s leadership competencies are assessed most positively when the candidate fits an “overall leadership . . . prototype.”\(^80\) Studies have found shocking results within this framework, as “being [w]hite” was viewed by most subjects as part of the leadership prototype.\(^81\) Another study found that “the preponderance of psychological research suggests that women and men alike expect men to be superior at

\(^75\) Brummer & Strine, supra note 73, at 11.
\(^76\) Id. at 12.
\(^77\) OUT LEADERSHIP, supra note 45, at 10.
\(^78\) Brummer & Strine, supra note 73, at 10–11.
\(^79\) Dühr, supra note 20, at 49.
\(^80\) Id.
business activities.” 82 Thus, one prevailing reason for the lack of diversity in corporate boardrooms is the cognitive biases in our current business world.

Second, it is also likely that the closed networks of corporate officers and directors erect high barriers for female, underrepresented minority, and LGBTQ+ candidates to overcome. One study, from 2018, found that while 94% of U.S. companies surveyed said they looked for diverse board candidates, 77% looked to referrals from current directors when identifying candidates. 83 A qualitative study in Norway found that “[b]oard seats tend to be filled by directors engaging their networks, and the resulting appointees tend to be of the same socio-demographic background.” 84 Another 2016 survey of more than 1,000 directors found that over one-third of all white directors were already known by the CEO when introduced to the board. 85 Therefore, before the implicit biases in corporate America even take place, diverse candidates are already excluded from consideration.

Given the slow pace of increased representation in corporate boardrooms and the obstacles to achieving greater representation, external pressure is needed. An obvious starting point is regulation. However, current regulation in the United States has largely failed to implement much change. Nasdaq’s new listing rules are an important, yet likely flawed, step explored further in Part II of this Comment.

II. NASDAQ’S DIVERSITY PROPOSAL

A diverse boardroom can serve as a catalyst in diversifying a corporation due to spillover into executive positions and the reputational capital it creates for diverse job-seekers. However, implicit and explicit obstacles stand in the way of achieving inclusion in the boardroom and seeing the effects of this catalyst. Therefore, regulation is needed to overcome the obstacles diverse director candidates face. Part II of this Comment dives deeper into the promulgation of Nasdaq’s diversity rules, first beginning with the SEC’s current regulatory

84 Diirr, supra note 20, at 11, 53.
approach, then highlighting key differences in Nasdaq’s new diversity rules and setting the stage for the potential failings of Nasdaq’s Diversity Inclusion Rule.

A. The U.S. Approach to Board Diversity

Following the 2008 financial crisis, the SEC viewed increased corporate transparency as part of its response to prevent further crises. Accordingly, the SEC began promulgating rules to increase disclosure requirements to give investors more meaningful information related to director voting. In a proposed amendment under the 1934 Exchange Act, the SEC requested comments on requiring board nominating committees to consider diversity. After many comments supporting the notion, the SEC adopted a final rule that required publicly traded firms to disclose in proxy statements whether, and, if so, how, the corporation considers diversity in identifying director nominees. If a company’s nominating committee has a policy for considering diversity when identifying diverse director candidates, the SEC rule requires the company to disclose how the committee implements the policy and how it assesses the policy. The SEC decided not to define diversity but instead allowed firms “to define diversity in ways they consider appropriate.” Thus, without a required definition, diversity can be anything to a company choosing to disclose its approach. For instance, the SEC release adopting the Rule explained that companies may consider diversity of backgrounds, experience, or education as part of their policy instead of diversity of race, gender, or sexual orientation.

Currently, the SEC does not require board composition disclosures; however, many companies have begun to do so. For instance, in 2019, forty-

88 Id. at 68343. 
89 Id.; see also DHR, supra note 20, at 176. 
91 Proxy Disclosure Enhancements, Exchange Act Release No. 33-9089, 74 Fed. Reg. at 68344. For instance, a company may decline to disclose whether it does consider diversity, but if the company does choose to do so, it must provide its approach to considering diversity. Id. The SEC does not oversee or mandate any particular approach considered by disclosing companies. See id.
92 Id.
93 Id.
five Fortune 100 companies disclosed diversity board data. While the number of disclosures regarding board diversity is high among the largest corporations, the corporate boardroom remains largely homogenous, begging the question of whether disclosure requirements are enough to affect the board composition of corporate America. SEC Commissioner Allison Herren Lee has described disclosure as the SEC’s best “toolkit” for increasing diversity. When placing the SEC’s current diversity disclosure requirements in a global context, the regulatory framework falls on a much softer side compared to more progressive, harder diversity mandates in countries like Norway. However, in a country generally against quotas, an American regulatory entity is highly unlikely to adopt the hard quota models like those found abroad. Therefore, SEC has its hands tied behind its back, limited to a “toolkit” that effectively allows corporations to regulate themselves. Thus, exchanges like Nasdaq are unlikely options to effectuate change in corporate America.


95 See supra Section I.C.1; David Gelles, ‘Corporate America Has Failed Black America,’ N.Y. TIMES (June 6, 2020), https://www.nytimes.com/2020/06/06/business/corporate-america-has-failed-black-america.html. In addition to the SEC’s disclosure requirements, the EEOC requires all private sector employers with 100 or more employees to provide demographic workforce data, which includes data on race and gender, however, individual employers’ data is not made public to investors. 42 U.S.C. § 2000e-8(c). However, the EEO-1 does not require a company to disclose data for outside directors as they are not considered company employees. See id.


97 Darren Rosenblum, Diversity and the Board of Directors: A Comparative Perspective, in RSCH HANDBOOK ON CORPORATE GOVERNANCE 179, 185–86 (Afra Afsharipour & Martin Gelter eds., 2021).


99 For instance, Norway’s Quota Act requires 40% representation of each gender on public Norwegian corporate boards. Mari Teigen, Gender Quotas on Corporate Boards: On the Diffusion of a Distinct National Policy Reform, in FIRMS, BOARDS AND GENDER QUOTAS: COMPARATIVE PERSPECTIVE 115, 124 (Mari Teigen & Frederick Engelstad eds., 2012). In 2009, the 40% representation of each gender had been met. Id. Mandated quotas abroad, such as Norway’s, have largely been successful in increasing board diversity. Rosenblum, supra note 97, at 185–86.

100 Many commentators see increased diversity disclosures soon for the SEC. See Sophia Hudson, Preparing for Potential Updates to HCM and Board Diversity Disclosure Requirements, HARV. L. SCH. F. ON CORP. GOVERNANCE (Oct. 18, 2021), https://corpgov.law.harvard.edu/2021/10/18/preparing-for-potential-updates-to-hcm-board-diversity-disclosure-requirements/#. The current SEC Commissioners have publicly stated diversity is an issue they see as an area where the SEC should do more. See Herren Lee, supra note 96 (stating that the SEC is not where it needs to be “when diversity levels fall so short of representation in the
B. Nasdaq’s Initial Proposal to the SEC

On December 1, 2020, Nasdaq filed a proposed change to its listing rules with the SEC pursuant to Section 19(b) of the 1934 Exchange Act. This section analyzes Nasdaq’s initial proposal for the new diversity rules and the arguments it used to justify its proposal.

The first component of Nasdaq’s proposal is its mandatory Diversity Matrix Rule under Listing Rule 5606(a). The Diversity Matrix Rule requires all Nasdaq-listed companies to “annually provide its board-level diversity data in a format substantially similar to the Board Diversity Matrix.” The Board Diversity Matrix is a disclosure form comparable to the EEOC’s EEO-1 form. The Matrix allows companies to give statistical data on the diversity composition of their board in a consistent format to other companies. According to Nasdaq, the Diversity Matrix Rule gives “stakeholders” consistent, comparable disclosure of board diversity data. This consistency comes from its uniform definition of diversity that applies to all subjected companies. Thus, unlike the SEC’s current approach that allows companies to define diversity in whatever way they wish, Nasdaq’s approach gives investors uniform and comparable data.

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103 Id.

104 Id. at 80486, 80493.

105 Id.

106 Id. at 80493. The Diversity Matrix Rule would also allow Nasdaq to assess whether a company has two diverse directors in accordance with the Diversity Inclusion Rule under 5605(f). Id. at 80486.

107 Id. at 80493.

108 Id.
To further provide stakeholders a level of consistency, Nasdaq also chose a narrow definition of diversity.\textsuperscript{109} The Diversity Matrix Rule articulates this definition, requiring all subjected companies to disclose their number of directors according to gender identity (“male, female, or non-binary”), ethnicity (“African American or Black, Alaskan Native or American Indian, Asian, Hispanic or Latinx, Native Hawaiian or Pacific Islander, White, or Two or More Races or Ethnicities”), and sexual orientation (“lesbian, gay, bisexual, transgender or a member of the queer community”).\textsuperscript{110} The Diversity Matrix Rule also allows directors to leave their racial, sexual orientation, and gender identities “[u]ndisclosed.”\textsuperscript{111}

Nasdaq allows companies the flexibility to provide the statistical disclosure in either a proxy statement, information statement, or on the company’s website.\textsuperscript{112} When a company does not timely provide the required disclosures in any format, Nasdaq first notifies the company of its noncompliance and allows it forty-five days to submit a plan to regain compliance.\textsuperscript{113} Next, Nasdaq assesses the plan and gives the company 180 days to regain compliance.\textsuperscript{114} Finally, if the company does not regain compliance within that timeframe, Nasdaq will delist the company from the exchange, subject to appeal.\textsuperscript{115}

In tandem with the Diversity Matrix Rule, Nasdaq proposed listing Rule 5605(f)(2), or the Diversity Inclusion Rule, which is the main subject of this Comment and much of the other commentary surrounding the listing rule changes.\textsuperscript{116} The Diversity Inclusion Rule requires listed companies to have at least two members of their board of directors self-identify as diverse, including at least one self-identifying female and one self-identifying underrepresented

\textsuperscript{109} Id.
\textsuperscript{110} Id. at 80486. Nasdaq’s diversity definition is based on EEOC’s EEO-1 report but also includes reporting LGBTQ+ data. Id. Nasdaq believed that including LGBTQ+ in its definition was important considering the U.S. Supreme Court found that sexual orientation is intertwined with gender in its decision in \textit{Bostock v. Clayton County}. Id. Nasdaq also proposed certain exceptions for foreign-listed companies where underrepresented minorities may not have the same narrow definition as Nasdaq proposes. Id. at 80487. Nasdaq defines “Underrepresented Individual in Home Country Jurisdiction” for these Foreign Issuers as people that self-identify as an underrepresented individual in the Foreign Issuer’s home country. Id.
\textsuperscript{111} Id. at 80486.
\textsuperscript{112} Id. at 80487. If a company chooses to publish its disclosure on its website, then the company is also required to send its disclosure data to Nasdaq’s Listing Center within fifteen days of its annual shareholder meeting. Id.
\textsuperscript{113} Id. at 80488.
\textsuperscript{114} Id.
\textsuperscript{115} Id.
\textsuperscript{116} Id.
minority or LGBTQ+ person. However, as a comply-or-explain rule, the Diversity Inclusion Rule allows companies to not have two diverse directors by publishing an explanation of why they do not. The definition of diversity applicable to the Diversity Matrix Rule disclosure requirement also applies to the Diversity Inclusion Rule. The two listing rules work in tandem as Nasdaq assesses a firm’s compliance with the Diversity Inclusion Rule by examining its diversity data from the Diversity Matrix Rule.

In Nasdaq’s initial proposal, a company that chooses to explain why it does not have two diverse directors may publish its explanation either in its proxy statement or on its website. Nasdaq clarifies in its proposal that it will not assess the quality of the explanation of a non-adopting company. However, when a company fails to comply with any aspect of the Diversity Inclusion Rule by either not having two diverse directors or not giving an explanation, Nasdaq’s Listing Qualifications Department will tell the company that it has until the later of its next annual shareholder’s meeting or 180 days to cure the failure. If the company does not cure the deficiency in the specified amount of time, Nasdaq will delist the company, subject to appeal.

Nasdaq’s Diversity Inclusion Rule, together with the Diversity Matrix Rule, is a giant leap forward from the SEC’s current disclosure framework for increasing the number of diverse directors in American corporations. Important to Nasdaq’s Diversity Inclusion Rule, and often overlooked, is that the Diversity Matrix Rule, which requires the disclosure of board statistics, applies to listed companies regardless of whether the company complies with the diversity target of having two diverse directors. As Nasdaq highlighted in its proposal, this disclosure requirement allows investors to compare important diversity data from different firms with a consistent and narrow definition of diversity.

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117 Id. Nasdaq also proposed certain exceptions to Rule 5605(f)(2) for smaller companies and foreign issuers. Id. at 80489. Both smaller companies and foreign issuers may satisfy Rule 5605(f)(2)’s requirements by having two female directors or one female and one director who identifies as LGBTQ+ or an underrepresented minority, or of course, explaining why the company is unable to do so. Id.

118 Id. at 80488.


121 Id. at 80488.

122 Id.

123 Id. at 80490.

124 Id.

125 See id. at 80493.

126 See id. at 80486.
diversity.\textsuperscript{127} Therefore, Nasdaq’s framework is essentially a disclosure rule—albeit a quiet one—hidden behind a more invasive comply-or-explain diversity target in the Diversity Inclusion Rule.

One noticeable and important aspect of Nasdaq’s initial proposal is its use of the term “stakeholder.”\textsuperscript{128} Stakeholder governance has become a larger part of today’s corporate law discussion.\textsuperscript{129} The increasing presence of stakeholder governance is reflected in the SEC’s Proxy Disclosure Enhancements Rule release in 2009, which does not mention stakeholders apart from investors, whereas Nasdaq’s proposal in 2020 considers the impacts that corporations have on all stakeholders.\textsuperscript{130} Growing from concerns that corporations negatively impact their stakeholders beyond shareholders, stakeholder governance largely rejects the theory that corporate board members should focus only on profits for shareholders.\textsuperscript{131} Instead, stakeholder governance focuses on all stakeholders and the impacts a corporation may have beyond investor returns.\textsuperscript{132} As evidenced by the language in its proposal to the SEC, Nasdaq appears to adhere to this stakeholder-focused view.\textsuperscript{133} Some argue that due to the power allocated to corporations in American society, American corporations have swung corporate law to the right, obstructing any political reform to the corporation as an institution.\textsuperscript{134} Yet, as an SRO, Nasdaq has successfully implemented reform, insulated from any corporate captured political obstructionism.\textsuperscript{135}

\textsuperscript{127} See \textit{id. at 80486, 80493.}

\textsuperscript{128} \textit{Id. at 80472. Black’s Law Dictionary} defines stakeholder as “[s]omeone who has an interest or concern in a business or enterprise, though not necessarily as an owner.” \textit{Stakeholder, BLACK’S LAW DICTIONARY} (11th ed. 2019).

\textsuperscript{129} See generally Leo E. Strine, Jr., \textit{Restoration: The Role Stakeholder Governance Must Play in Recreating a Fair and Sustainable American Economy: A Reply to Professor Rock}, \textit{76 BUS. LAW.} 397, 399–401 (2021) (arguing for corporations and their directors to consider the impacts and effects a corporation has beyond stockholders).

\textsuperscript{130} \textit{Compare Proxy Disclosure Enhancements, Exchange Act Release No. 33-9089, 74 Fed. Reg. 68334, 68334 (Dec. 16, 2009)} (“[I]nvestors have increasingly focused on corporate accountability and have expressed the desire for additional information that would enhance their ability to make informed voting and investment decisions.” (emphasis added)), \textit{with Self-Regulatory Organizations, Exchange Act Release No. 34-90574, 85 Fed. Reg. at 80472} (“The benefits to stakeholders of increased diversity are becoming more apparent and include an increased variety of fresh perspectives, improved decision making and oversight, and strengthened internal controls.”) (emphasis added)).

\textsuperscript{131} See Strine, \textit{supra}, note 129, at 399–401.

\textsuperscript{132} See \textit{id.}


\textsuperscript{134} See Strine, \textit{supra} note 129, at 421–23; \textit{see also} Accountable Capitalism Act, S. 3215, 116th Cong. § 6(b)(1) (2020) (proposing an act that would balance the interests of all American corporations’ stakeholders).

Nasdaq’s proposal also highlights its use of comply-or-explain as a model of corporate governance regulation with its Diversity Inclusion Rule.\footnote{Id. at 80488.} Comply-or-explain governance is a soft form of corporate governance regulation due to its self-regulation principles.\footnote{See Rosenblum, supra note 97, at 185 fig.9.1.} Typically, as is the case internationally and even in some current U.S. codes, comply-or-explain governance uses disclosure as the “comply” part of the regulation.\footnote{See id. at 185 & fig.9.1.} However, Nasdaq takes a fairly different approach by mandating disclosure through the Diversity Matrix Rule regardless of whether a company complies or explains.\footnote{Self-Regulatory Organizations, Exchange Act Release No. 34-90574, 85 Fed. Reg. at 80486.} Also, Nasdaq makes the “comply” of its Diversity Inclusion Rule a targeted quota instead of disclosure.\footnote{See id. at 80488.} This approach elevates Nasdaq’s Diversity Inclusion Rule from a softer governance code to a more moderate one.\footnote{See Rosenblum, supra note 97, at 185 fig.9.1.} Thus, Nasdaq has inventively threaded the needle of the various diversity board approaches, all the while still mandating a more comprehensive annual disclosure in its Diversity Matrix Rule.

Finally, Nasdaq’s proposal clarifies that Nasdaq will not oversee or regulate the quality of non-adopting explanations under its Diversity Inclusion Rule.\footnote{Self-Regulatory Organizations, Exchange Act Release No. 34-90574, 85 Fed. Reg. at 80486.} For instance, Nasdaq’s only requirement is to explain that the company is subject to Rule 5605(f)(2).\footnote{See id. at 80488.} After that, the company can explain why it has failed to comply with the Rule for any reason it sees fit.\footnote{See id. at 80502.} This lack of oversight gives considerable flexibility to subjected companies. A company also has flexibility when it publishes its Diversity Inclusion Rule explanation and Diversity Matrix Rule data, specifically the option to publish the information on the company’s website.\footnote{Id.} Other than requiring that the company provide the website name of the explanation disclosure to the Nasdaq Listing Qualifications Department to prove that the company has complied, there are no other specific requirements for where the explanation must be on a company’s website.\footnote{Id. at 80502.} Therefore, a noncomplying company hostile to the new diversity rules could give an arbitrary explanation while burying the Diversity Inclusion Rule explanation and Diversity Matrix Rule data on an obscure company webpage. Thus, it raises the question of whether homogenous board companies will comply or take...
advantage of the flexibility Nasdaq allows for in its Diversity Inclusion Rule and Diversity Matrix Rule.\footnote{147}

C. The Comments, Nasdaq’s Response, and the SEC Approval

The SEC published Nasdaq’s proposal for comment in the Federal Register on December 11, 2020.\footnote{148} The proposal received over 200 comments, with a majority supporting the proposal.\footnote{149} Among the supporting comments, many argued that Nasdaq’s proposal improves corporate governance, creates transparency, advances board diversity, and heightens corporate performance.\footnote{150} On the other hand, commenters who opposed the proposal argued it focused on irrelevant surface characteristics, would lead to tokenism, violated Title VII of the Civil Rights Act of 1964, and was unconstitutional.\footnote{151}

In its first response to commenters, Nasdaq addressed those that argued the Diversity Inclusion and Diversity Matrix Rules were violations of Title VII of the Civil Rights Act of 1964 and unconstitutional.\footnote{152} By definition, independent or outside directors, Nasdaq explained, are not company employees and thus not subject to Title VII.\footnote{153} Furthermore, Nasdaq explained that 78% of the directors currently sitting on the boards of Nasdaq-listed companies are outside directors, and thus, companies could still meet the Diversity Inclusion Rule’s diversity

\footnote{147}{On the same day as its proposal for the Diversity Inclusion Rule 5605 and the Diversity Matrix Rule 5606, Nasdaq separately proposed Listing Rule IM-5900-9. Self-Regulatory Organizations, Exchange Act Release No. 34-90571, 85 Fed. Reg. 79556 (Dec. 4, 2020). Through a partnership with Equilar, a corporate leadership data and board recruiting service, Nasdaq’s Listing Rule IM-5900-9 provides companies that currently did not have two diverse directors with one-year complimentary access to Equilar’s board recruiting service. See id.; Nasdaq Partners with Equilar, NASDAQ, https://www.nasdaq.com/board-diversity/partnerships/equilar (last visited Jan. 25, 2023). One source that commentators have identified as a cause of low board diversity levels is the adherence to informal networks among board members, which creates a high barrier for diverse board-ready candidates. DHIR, supra note 20, at 38. By providing companies access to a recruiting service that can identify qualified and diverse board candidates, Nasdaq’s proposed Listing Rule IM 5900-9 can eliminate the barriers these informal networks create while also complimenting Nasdaq’s Diversity Inclusion Rule. Self-Regulatory Organizations, Exchange Act Release No. 34-90571, 85 Fed. Reg. at 79556–58.}


\footnote{150}{Id. at 2.}

\footnote{151}{See id. at 3–4, 7; Email from Stephen J. Kastenberg, Att’y, Ballard Spahr LLP on behalf of The Nasdaq Stock Market LLC, to Vanessa Countryman, Secretary, U.S. Sec. & Exch. Comm’n 1–2 (Feb. 5, 2021) [hereinafter Email from Kastenberg], https://www.sec.gov/comments/sr-nasdaq-2020-081/srnasdaq2020081-8343758-228925.pdf.}

\footnote{152}{Email from Kastenberg, supra note 151, at 1–2.}

\footnote{153}{Id. at 6.}
objective of two diverse directors and comply with Title VII. As for the constitutional issues commenters raised, Nasdaq argued that, as an SRO, it is not a state actor and thus not subject to any constitutional claim. In addition, Nasdaq argued its proposed rules are not “fairly attributable” to the state, which, if so, would subject Nasdaq to constitutional standards. Commenters also raised constitutional privacy issues regarding the self-identification aspect of the Diversity Matrix Rule. Nasdaq argued that because the self-identification was voluntary, as it allowed for an “undisclosed” option for directors, Nasdaq did not violate constitutional privacy issues. Finally, Nasdaq argued that even if its new listing rules were subject to heightened scrutiny, they would satisfy all levels of scrutiny due to the flexible approach that the rules allow.

Finally, in responding to comments that characterized Nasdaq’s Diversity Inclusion Rule 5605(f)(2) as a mandate, Nasdaq doubled down on its flexible and deferential approach. Nasdaq’s Chief Legal and Regulatory Officer explained that Rule 5605(f)(2) is not a mandate because a company has the option to adopt the diversity target or explain why it did not. Furthermore, the officer elaborated that Nasdaq will not assess a non-adopting company’s explanation but only ensure that the explanation specified the applicable requirements of Rule 5605(f)(2). Therefore, once a regulated company explains that it is subject to Rule 5605(f)(2), it then “can choose to disclose as much, or as little, insight into the company’s circumstances or diversity

154 Id. at 7.
155 Id. at 9. Nasdaq cited several cases addressing the issue whether Nasdaq is a state actor, namely Desiderio v. NASD, id. at 9–10, 10 n.25, as well as other precedent addressing whether NYSE or SROs more generally are state actors, specifically United States v. Solomon and Santos-Buch v. Financial Industry Regulatory Authority, Inc., id. at 10 n.25.
156 Id. at 11. Nasdaq relied on the Blum test from Blum v. Yaretsky, which finding that actions are fairly attributable to the state when there is “a sufficiently close nexus between the [s]tate and the challenged action,” and . . . the state has ‘exercised coercive power’ or provided ‘such significant encouragement’ that the choice must be ‘deemed to be that of the state.’” Id. (quoting Blum v. Yaretsky, 457 U.S. 991, 1004–05 (1982)).
157 Id. at 13–14. Nasdaq also explained that because it modeled Rule 5606’s disclosure requirement after the EEOC’s EEO-1, it was not subject to constitutional privacy concerns as shown in EEOC v. Ass’n of Community Organizations for Reform Now. Id. at 14.
158 See id. at 17. Nasdaq examined the Rule at each level of scrutiny, but anchored its argument that if a court did subject the Rule to any level of scrutiny it would be rational basis. Id. at 15. However, Nasdaq argued that at intermediate and strict scrutiny the Rule survives because it believes that it is necessary to achieve a compelling purpose of perfecting the mechanisms of a free and open market and narrowly tailored to achieve that interest by being flexible and neither over- nor under-inclusive. Id. at 17–22.
159 Id.
160 Letter from Zucca, supra note 149, at 7.
161 Id.
philosophy as the company determines.” Nasdaq offered an example of a sparse but sufficient explanation: “The Company does not meet the diversity objectives of Rule 5605(f)(2)(C) because it does not believe Nasdaq’s listing rule is appropriate.”

Following Nasdaq’s responses to comments, the SEC Commissioners voted along party lines to approve Nasdaq’s proposal in August of 2021. SEC Chair Gary Gensler and Commissioners Herren Lee and Caroline Crenshaw voted in favor of the proposal. The remaining Commissioners, Elad Roisman and Hester Peirce, voted against the proposal. In its approving order, the SEC explained that under Section 19(b) of the 1934 Exchange Act, the SEC must approve a proposal so long as it finds the proposal consistent with the requirements of the Act, which the majority of the commissioners did.

Nasdaq’s proposal to the SEC and its response to commenters evidences its emphasis on flexibility for subjected companies. While a flexible rule is appealing to give markets autonomy, it also allows hostile companies to subserve Nasdaq’s purpose of the Diversity Inclusion Rule by providing arbitrary explanations that do not allow shareholders to compare consistent information. Therefore, without increased enforcement, the Diversity Inclusion Rule may not lead to the increased diversity that Nasdaq promulgated it to do.

III. COMPLY-OR-EXPLAIN AND ITS POTENTIAL PROBLEMS

Nasdaq’s Diversity Inclusion Rule and Diversity Matrix Rule are important steps toward diversity and inclusion in the boardrooms of Nasdaq-listed companies and, consequently, corporate America. Focusing on the Diversity Inclusion Rule, which uses a comply-or-explain form of corporate governance, Part II briefly identified potential gaps that can be exploited by non-adopting companies that choose to explain rather than have two diverse directors. Part III of this Comment examines research of comply-or-explain corporate governance codes abroad and the various weaknesses researchers have identified. Part III first describes the comply-or-explain governance regime, tracing its origins to

163 Id. at 8. Nasdaq also offered the possibility of shareholders requesting additional information directly from the company if they need additional information to make an informed voting decision. Id.
164 Id.
165 Posner, supra note 9.
166 Id.
167 Id.
its wide adoption, mainly throughout Europe. Part III then examines the theory of effectiveness and enforcement of comply-or-explain governance, as well as the weaknesses inherent in comply-or-explain codes, and how those weaknesses will affect Nasdaq’s Diversity Inclusion Rule.

A. Comply-or-Explain: Soft-Law Governance and Disclosure Framework

The comply-or-explain governance model was first introduced in the United Kingdom in 1992, with the Report of the Committee on the Financial Aspects of Corporate Governance, also known as the Cadbury Report.\textsuperscript{169} Since 1992, the governance model has spread throughout the world, most prevalently in Europe.\textsuperscript{170} Early codes, such as the code implemented in the United Kingdom, responded to business scandals of financial mismanagement.\textsuperscript{171} However, increasingly, “codes of good governance,” as they are sometimes referred to abroad, have included more aspirational, nonfinancial goals, including ESG reporting.\textsuperscript{172}

Nasdaq’s Diversity Inclusion Rule follows the comply-or-explain approach, which is designed to give flexibility to companies, unlike mandatory codes. Under comply-or-explain models, a regulatory authority promulgates a code “reflecting . . . best practices.”\textsuperscript{173} Regulated companies then choose to comply with the code in one of two ways: adopting the best practice or publishing an explanation of why it has not done so.\textsuperscript{174} Therefore, a firm is non-compliant if it both fails to implement the code’s best practices and fails to explain why.\textsuperscript{175} The governance model is often described as a one-size-fits-all approach, where regulators adopt core principles and allow regulated companies greater variation in their adoption of such principles by explaining their reason for doing so.\textsuperscript{176}

So long as a firm is compliant in one of the two possible ways, regulatory bodies generally do not assess a firm’s complying explanations under comply-

\textsuperscript{169} Keay, supra note 17, at 280; see also REPORT OF THE COMMITTEE ON THE FINANCIAL ASPECTS OF CORPORATE GOVERNANCE (Dec. 1992), http://www.ecgi.org/codes/documents/cadbury.pdf.


\textsuperscript{171} Heike Mensi-Klarbach, Stephan Leinninger & Michael Schiffringer, The Carrot or the Stick: Self-Regulation for Gender-Diverse Boards via Codes of Good Governance, 170 J. BUS. ETHICS 577, 579 (2019).

\textsuperscript{172} Id.; see also Harper Ho, supra note 170, at 321–22.

\textsuperscript{173} Id.

\textsuperscript{174} Harper Ho, supra note 170, at 321.

\textsuperscript{175} Id.

\textsuperscript{176} Id.
or-explain regimes.\textsuperscript{177} When a firm complies by explaining its non-adoption, enforcement occurs through shareholders assessing the adequacy of the company’s explanation.\textsuperscript{178} With their assessment, shareholders may see a company’s shares as more or less appealing.\textsuperscript{179} Therefore, the market serves as the true enforcer, theoretically reflecting the quality of a firm’s compliance with the code.\textsuperscript{180} Thus, comply-or-explain is a disclosure-based method of governance, giving relevant information to shareholders.\textsuperscript{181} Essential to this equation, however, is the availability of the information to shareholders.\textsuperscript{182} Therefore, regulators generally require companies to disclose their statement of compliance or explanation of non-adoption in state-required disclosures or proxy statements.\textsuperscript{183}

An inherent quality of comply-or-explain governance models that makes them attractive for regulators is their flexibility. An alternative to harder forms of governance, comply-or-explain mixes consistency and flexibility among regulated firms by combining mandatory and voluntary governance.\textsuperscript{184} Comply-or-explain governance is mandatory in that all regulated companies must either comply or explain; however, it also reflects a form of self-regulation in that adoption of the targeted practice is not required.\textsuperscript{185}

Nasdaq specifically cites flexibility as one key reason for using the comply-or-explain approach for its Diversity Inclusion Rule.\textsuperscript{186} Furthermore, Nasdaq believed the comply-or-explain approach “would be more palatable to the U.S. business community than a mandate.”\textsuperscript{187} Nasdaq explained that companies would be more responsive to a flexible, disclosure-based approach due to it being “less controversial.”\textsuperscript{188} However, research conducted abroad of comply-

\textsuperscript{177} Keay, supra note 17, at 282.
\textsuperscript{178} Id. at 280.
\textsuperscript{179} Id. at 282.
\textsuperscript{180} Id. at 282–83.
\textsuperscript{182} See Harper Ho, supra note 170, at 329.
\textsuperscript{183} Id.
\textsuperscript{184} Id. at 330.
\textsuperscript{185} Id.
\textsuperscript{187} Id.
\textsuperscript{188} Id.
or-explain codes shows flaws that Nasdaq largely ignores in its initial proposal.\(^{189}\)

B. Failures of Comply-or-Explain Governance

Comply-or-explain governance codes have gained popularity due to their flexibility for regulated companies while promoting consistent, comparable data for shareholders.\(^{190}\) Yet, research of their effectiveness in international jurisdictions has identified several weaknesses. This section surveys those weaknesses and how they apply to Nasdaq’s Diversity Inclusion Rule, examining, first, the enforcement mechanism of comply-or-explain codes, proposing that it may be lacking in American markets, including Nasdaq. Next, this section explains how, as a result of a lack of enforcement, regulated company behavior in a comply-or-explain regime will be less than sufficient, resulting in perfunctory explanations. Third, and finally, this section observes that these weaknesses are compounded by the controversiability of Nasdaq’s Diversity Inclusion Rule, which leads to a lack of early adopters, a step that has shown to be necessary to comply-or-explain codes.

First, it is important to note that comply-or-explain regimes effectively motivate regulated firm compliance, particularly in developed capital markets.\(^{191}\) In a comply-or-explain regime, compliance means one of two things: adopting a code’s best practice or an explanation for not adopting.\(^{192}\) Therefore, since a code’s purpose is to increase regulated companies’ adoption of the targeted practice, comply-or-explain literature focuses on how a code can increase adoption rather than explanation.\(^{193}\) However, the two are interdependent, as the market incentivizes adoption through negative reactions to insufficient explanations.\(^{194}\)

One fundamental reason for the lack of adoption of a comply-or-explain code’s target practice is “the passive position taken by investors.”\(^{195}\) As previously mentioned, the comply-or-explain approach is enforced through

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\(^{189}\) See id. at 80488; see Harper Ho, supra note 170, at 331–39.


\(^{191}\) Harper Ho, supra note 170, at 332.

\(^{192}\) Id. at 321.


\(^{194}\) Id. at 80484–85, 80488.

\(^{195}\) Rients Abma & Mieke Olaerts, Is the Comply or Explain Principle a Suitable Mechanism for Corporate Governance Throughout the EU?: The Dutch Experience, 9 EUR. CO. L. 286, 288 (2012).
market forces. As a result, it relies heavily on active investors who are more willing to assess a firm’s compliance with a code and change their investments and behavior accordingly. In the United Kingdom, where comply-or-explain codes originated, institutional investors like hedge funds were seen as viable enforcers of such early codes. However, in countries where passive investing is largely prevalent, comply-or-explain codes can go largely unenforced, leading to minimal adoption of a code’s target practice.

In a developed capital market like the United States, this may not seem like a major issue, with the prominence of hedge funds and other large active investors. Today, however, passive investing makes up almost half of the U.S. stock market through passive management funds that automatically track indexes, like the Nasdaq Composite Index. As of 2019, the market share of index funds, exchange-traded funds (“ETFs”), and other forms of passive investing have risen to 45%, up 25% from a decade before. The Nasdaq Composite is one of the most widely followed stock indexes in the world, along with the Dow Jones Industrial Average and S&P 500, and is one in which many passive funds trade and exclusively follow.

Nevertheless, many of these ETFs and other passive investing funds are managed by large asset managers, who actively exert considerable influence through their investment choices. Specifically, three large asset management funds, Vanguard, Blackrock, and State Street, manage a combined $22 trillion in investments, making up around one quarter of all votes at shareholder meetings.

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196 See supra notes 176–82 and accompanying text.
197 See supra notes 176–82 and accompanying text.
198 See Harper Ho, supra note 170, at 337.
199 See supra notes 176–82 and accompanying text.
202 Id.
meetings of most S&P 500 companies. Known as “the Big Three,” these asset management firms have widely adopted ESG initiatives as conditions for companies that they invest, perhaps as part of a strategy to attract diverse, qualified talent. For instance, Blackrock’s 2022 voting guidelines state that “boards should aspire to 30% diversity of membership and encourage companies to have at least two directors on their board who identify as female and at least one who identifies as a member of an underrepresented group.” However, recently, the three firms have faced growing opposition for their ESG initiatives and growing influence. Such pushback is part of a broader backlash to ESG initiatives in the midst of an uncertain economic outlook. The backlash is starting to affect these asset manager’s own initiatives and even bottom lines.

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204 *Id.*; Lucian Bebchuk & Scott Hirst, *The Specter of the Giant Three*, 99 B.U. L. REV. 721, 736 (2019) (“[T]he average share of the votes cast at S&P 500 companies at the end of 2017 was 8.7% for BlackRock, 11.1% for Vanguard, and 5.6% for SSGA. As a result, for S&P 500 companies, the proportion of the total votes that were cast by the Big Three was about 25.4% on average…”).

205 Manjoo, supra note 203.


For instance, Vanguard recently decided to back out of the Net Zero Asset Managers initiative, a major investment industry initiative focused on tackling climate change. Wary of the influence that these asset managers can exert on their portfolio companies, Congress has introduced viable legislation to take away the voting power of these large asset managers in the INDEX Act, which would require investment advisors of index funds to vote according to their investors’ instructions, and the House Financial Services Committee recently formed a “Republican E.S.G. Working Group” focused on limiting the spread of the ESG movement in financial markets. While the ESG initiatives of the largest asset managers are commendable, the mounting pressure against ESG and their influence makes it possible that they cannot be relied on for implementing important boardroom change. Nevertheless, it may not be desirable to have such large institutions controlling so much of our economy and the composition of boardrooms, as the initiatives can cut both ways. Therefore, to fully strengthen Nasdaq’s Diversity Inclusion Rule, any amendment should take notice of the literature on passive investors in comply-or-explain regimes, as Nasdaq’s Diversity Inclusion Rule may still suffer from a lack of enforcement and minimal adoption due to the large amount of passive investing that takes place on the exchange.

Second, following from the lack of shareholder enforcement, is the concern that companies will give perfunctory explanations when deviating from a comply-or-explain code, and thus only a small number of firms will adopt the code’s targeted practice. As previously explained, the main benefit of comply-or-explain regimes is the flexibility it gives companies when implementing a code as long as they explain their reasoning. Regulators typically do not assess the explanations of non-adopting companies under comply-or-explain regimes, leaving the enforcement to the market. However, in practice, non-adopting companies often give vague and less-than-quality explanations.

212 Gelles, supra note 209.
213 See generally Shriber, supra note 202 (listing three major Nasdaq Composite ETFs that track and invest in each of the 3,000 plus securities listed on the Nasdaq Stock Exchange).
214 See Abma & Olaerts, supra note 195, at 288.
216 Keay, supra note 17, at 282.
217 Abma & Olaerts, supra note 195, at 288.
in 2009, the European Commission reviewed comply-or-explain reporting and found that despite popular support for codes in surveyed jurisdictions, 39% of explanations were adequate.\(^{218}\) Moreover, when passive investing makes up a large market share, deficient explanations are more likely.\(^{219}\) In one study of United Kingdom comply-or-explain codes, researchers found that many non-adopting companies kept the same explanation year-to-year, never modifying their explanations.\(^{220}\) The researchers attributed the unchanged explanations to the large number of passive shareholders who did not attach sufficient importance to explanations to compel the companies to give meaningful explanations.\(^{221}\) In general, a sufficient explanation in a comply-or-explain code should provide investors with consistent information that will allow them to compare regulated companies.\(^{222}\) Since enforcement of comply-or-explain codes is left to the market, sufficient explanations are necessary to allow shareholders to make informed investment decisions.\(^{223}\) Therefore, the effectiveness of a comply-or-explain code is weakened when there are high numbers of deficient explanations, as shareholders cannot make informed investment decisions.\(^{224}\) Thus, without greater oversight and increased explanation requirements, the enforcement mechanism of a comply-or-explain code will be insufficient and ultimately lead to minimal adoption of the code’s best practice, as companies will feel negligible market pressure.\(^{225}\)

Nasdaq’s Diversity Inclusion Rule 5605(f)(2) does not conduct any oversight of explanations or requirements for the quality of explanations other than a firm explaining that it is not in compliance with the code.\(^{226}\) As Nasdaq explained, a company could offer as little information as it wants in its explanation, offering the following example of a sufficient explanation: “The Company does not meet the diversity objectives of Rule 5605(f)(2)(C) because it does not believe

\(^{218}\) Harper Ho, supra note 170, at 333; see also David Seidl, Paul Sanderson & John Roberts, Applying the ‘Comply-or-Explain’ Principle: Discursive Legitimacy Tactics with Regard to Codes of Corporate Governance, 17 J. MGMT. & GOVERNANCE 791, 807 (2013) (finding “well over 50%” of explanations under a German comply-or-explain regime to be deficient).

\(^{219}\) Abma & Olaerts, supra note 195, at 288–89.


\(^{221}\) See id.

\(^{222}\) See Sergakis, supra note 181, at 408.

\(^{223}\) See Keay, supra note 17, at 282.

\(^{224}\) Seidl et al., supra note 218, at 814.

\(^{225}\) Id. at 813–14.

Nasdaq’s listing rule is appropriate.”\textsuperscript{227} What is more, one study found that explanation instead of adoption was most common when a comply-or-explain code created controversial standards.\textsuperscript{228} Nasdaq’s Diversity Inclusion Rule is undoubtedly a controversial code, as evidenced by responses in the media and the courts.\textsuperscript{229} Therefore, without more oversight, Nasdaq’s goal of providing “consistent, comparable data across companies” is likely to fail to meet the needs of market enforcement since companies will give inconsistent, perfunctory explanations rather than have two diverse directors.\textsuperscript{230}

Third, the next issue expands on controversial comply-or-explain codes. Research illustrates that controversial standards built on “political goals such as gender equality originating from ethical rather than instrumental considerations” are less likely to be adopted through comply-or-explain codes.\textsuperscript{231} Widespread adoption of a comply-or-explain code’s targeted practice begins with early adopters recognizing the economic value of adopting the code.\textsuperscript{232} Then, once there are enough early adopters, perceived social pressure or “bandwagon pressure” leads the remaining companies to adopt, resulting in a successful code.\textsuperscript{233} However, controversial codes built on ethical considerations, like diversity inclusion, do not result in enough early adopters, as there is less perceived economic value in the code, and thus result in few adopters overall due to the lack of “bandwagon pressure.”\textsuperscript{234}

Since Nasdaq’s Diversity Inclusion Rule is a controversial code built on ethical rather than instrumental considerations,\textsuperscript{235} it reasons that Nasdaq will suffer from a lack of early adopters and, consequently, minimal adoption overall. However, researchers identified that such controversial codes “must exploit

\textsuperscript{227} Letter from Zecca, supra note 149, at 8.

\textsuperscript{228} Seidl et al., supra note 218, at 813–14.


\textsuperscript{231} Mensi-Klarbach et al., supra note 171, at 588.

\textsuperscript{232} Id. at 579.

\textsuperscript{233} Id. (internal quotations omitted).

\textsuperscript{234} See id. (internal quotations omitted).

\textsuperscript{235} See Arthur Levitt Jr., If Corporate Diversity Works, Show Me the Money, WALL ST. J. (Feb. 7, 2020, 6:00 PM), https://www.wsj.com/articles/if-corporate-diversity-works-show-me-the-money-11611183633 (“[D]iversity requirements are political at their core . . . .”).
additional forces” to be effectively built on ethical considerations. Therefore, Nasdaq’s Diversity Rule can still be effective, but it must amend it to do so. Part IV of this Comment offers amendments for Nasdaq to create additional forces to strengthen its Diversity Inclusion Rule and create lasting, meaningful change in the composition of boardrooms at Nasdaq-listed companies.

IV. A SOLUTION FOR NASDAQ’S DIVERSITY INCLUSION RULE TO REALIGN ENFORCEMENT AND ACHIEVE RESULTS

Comply-or-explain governance has inherent weaknesses that will limit the impact of Nasdaq’s Diversity Inclusion Rule. The weaknesses inherent in comply-or-explain codes stems from the fact that shareholders serve as the enforcement mechanism, a design that requires active investors with the necessary information to vote their share. Furthermore, codes built on controversial ethical considerations can compound these weaknesses due to fewer early adopters, resulting in the absence of social pressure on late adopters and, consequently, low adoption overall. Part IV of this Comment offers a solution for Nasdaq to fix its Diversity Inclusion Rule. First, Nasdaq should provide clear requirements for non-adopting explanations and, second, increase enforcement through a new supervisory and publication mechanism that will not disrupt individual firm governance. At the center of this solution is the importance of stakeholders to Nasdaq’s rules. Therefore, this Comment contends that enforcement must be placed in all stakeholders’ hands, not just those of the shareholders.

A. The Missing Piece: The Stakeholder

Important to the effectiveness of any corporate governance regime is the enforcement of the code. Nasdaq does not assess or enforce the quality of explanations for firms that fail to have two diverse directors; instead, its comply-or-explain approach relies on the market to enforce deficient explanations. This section argues that the comply-or-explain approach of Nasdaq’s Diversity Inclusion Rule is misaligned with the stakeholder governance focus that Nasdaq takes in its proposal.

236 Mensi-Klarbach et al., supra note 171, at 580.
237 See Keay, supra note 17, at 282.
A noticeable and important aspect of Nasdaq’s proposal to the SEC is the use of the term “stakeholder.”238 Using a term like stakeholder rather than shareholder is important language that shows Nasdaq’s intention when promulgating its Diversity Inclusion Rule. As Black’s Law Dictionary defines, a stakeholder is “[s]omeone who has an interest or concern in a business enterprise, though not necessarily as an owner.”239 Furthermore, the focus on stakeholder in Nasdaq’s initial proposal reflects the growing view of stakeholder governance, which holds that companies should consider all stakeholders and the impacts a company’s actions have beyond investor returns.240 However, the theory of comply-or-explain governance holds that enforcement of the code lies in the hands of shareholders and potential shareholders.241 While this precept implicates a larger subset of the population than just company shareholders due to the inclusion of potential shareholders, it nevertheless fails to include all stakeholders.

With only half of Americans owning stock, comprising nearly 50% of the market share in passive management funds that follow indexes like the Nasdaq Composite Index, Nasdaq’s chosen form of governance has excluded a large and more representative part of the population from enforcing the Diversity Inclusion Rule.242 While comply-or-explain governance is palatable to American markets, which have historically accepted disclosure frameworks that promote flexibility and rejected mandates, there is a clear misalignment in Nasdaq’s approach.243 Therefore, any amendment to Nasdaq’s Diversity Inclusion Rule must empower and include all stakeholders in the enforcement of the Rule to ensure meaningful change.

B. A Solution for Oversight and Increased Compliance

Since Nasdaq’s proposal to the SEC evokes a focus on stakeholder governance, the Diversity Inclusion Rule should focus on empowering all stakeholders with the enforcement of its code. This section offers a two-part amendment to Nasdaq’s Diversity Inclusion Rule to shift enforcement to all stakeholders, making for a more effective rule overall. First, Nasdaq should require more stringent guidelines for noncomplying explanations, taking

239 Stakeholder, BLACK’S LAW DICTIONARY (11th ed. 2019).
240 Strine, supra note 129, at 406–07.
241 See Keay, supra note 17, at 282–83.
242 Cox, supra note 200.
243 Rosenblum, supra note 98.
inspiration from an international jurisdiction. Second, Nasdaq should make both the data under the Diversity Matrix Rule and any firm’s explanations under the Diversity Inclusion Rule public on its website to provide comparable data to all stakeholders who may not have access to proxy statements or information statements nor consistently examine the websites of the more than 3,000 companies listed on the Nasdaq exchange.

1. A Set of Guidelines for Companies to Follow in Publishing Non-Adopting Explanations

The first recommendation of this Comment is for Nasdaq to amend its Diversity Inclusion Rule to require more stringent non-adopting explanations. As the Rule stands, Nasdaq does not oversee or regulate the quality of explanations for a company that fails to have two diverse directors. An explaining company only needs to explain that it is subject to Rule 5605(f)(2) and then may give any reason why it does not have two diverse directors. For instance, in responding to comments in the Federal Register, Nasdaq explained that a company could offer as little information as it wants in its explanation, offering the following example of a sufficient explanation: “The Company does not meet the diversity objectives of Rule 5605(f)(2)(C) because it does not believe Nasdaq’s listing rule is appropriate.” However, such deference to company discretion will compound the weaknesses that researchers have identified in comply-or-explain codes.

As explained in Part III, researchers have described as sufficient those explanations which are consistent with other regulated companies’ explanations, thus allowing interested shareholder to compare companies. Such explanations achieve the purpose of the comply-or-explain approach by giving the public comparable data so that the market can enforce the code. Nasdaq’s current Diversity Inclusion Rule would not lead to comparable, consistent explanations for companies without two diverse directors. According to research from international jurisdictions, controversial codes built on ethical considerations like Nasdaq’s are more likely to have a high percentage of

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245 Id.
246 Letter from Zecca, supra note 149, at 8.
247 See infra Section III.B.
248 See Sergakis, supra note 181, at 408.
249 Id.
explanations.\textsuperscript{250} Furthermore, international jurisdictions show that companies in practice typically have vague, uninformative explanations to comply-or-explain codes without stringent requirements for the quality of explanations.\textsuperscript{251} Nasdaq must amend its Diversity Inclusion Rule to provide increased requirements to companies for noncomplying explanations to avoid this risk of perfunctory explanations.

One comply-or-explain code that researchers have praised for its explanation requirements is the Swedish Corporate Governance Board’s code for exchange-listed companies.\textsuperscript{252} Importantly, unlike Nasdaq, the Swedish code requires companies to “state clearly which Code rules [they have] not complied with, explain the reasons for each case of noncompliance and describe the solution [they have] adopted instead.”\textsuperscript{253} When applied to Nasdaq’s Diversity Inclusion Rule, such requirements would take the Rule one step forward, giving insight into the different approach that a company takes, allowing shareholders to better understand the reasons for noncompliance, and eliminating any risk of mistaken ideas about the company.\textsuperscript{254} For instance, Nasdaq’s amended Listing Rule 5605(f)(3) could say: “If a Company satisfies the requirements of Rule 5605(f)(2) by explaining why it does not meet the applicable diversity objectives of Rule 5605(f)(2), the Company must: (i) specify the requirements of Rule 5605(f)(2) that are applicable; (ii) explain the reasons why it does not have two Diverse directors (or one Diverse director for Companies subject to Rule 5606(f)(2)(D)) . . .”\textsuperscript{255} and (iii) describe the approach to diversity that the company has adopted instead, its reason for doing so, and how it contributes to the governance of the company.

By ensuring that an explaining company gives its reasoning for its board composition and how that decision contributes to the governance of the company, the Diversity Inclusion Rule is in a better position to fulfill Nasdaq’s goal of providing “consistent, comparable data across companies,” achieving the

\textsuperscript{250} Seidl et al., supra note 218, at 799–800.
\textsuperscript{251} See Abma & Olaerts, supra note 195, at 288–89.
\textsuperscript{254} Sergakis, supra note 180, at 408.
goal of any comply-or-explain regime.\textsuperscript{256} However, the issue remains that explanations may still be ambiguous within this framework, especially given its higher level of stringency and the underlying controversial diversity standard.\textsuperscript{257} Therefore, incentives for companies to give well-reasoned explanations is needed, as well as a central location for all listed company diversity information to be available.

2. \textit{Institute Monitoring and Increased Publication of Listed Company Disclosures}

While an additional explanation requirement will give shareholders a better insight into a homogenous-board company’s diversity policy, the risk remains that companies may still give ambiguous answers to the three requirements to avoid a negative market reaction. Research abroad has identified that such deficient explanations are a weakness in comply-or-explain governance, partly due to the lack of shareholder monitoring, giving companies little incentive to provide sufficient explanations.\textsuperscript{258} To address this issue, Nasdaq must take two additional steps in a potential amendment. First, Nasdaq should provide companies a standard for explanations and increase the monitoring of company disclosures for deficient explanations, labelling companies that fail to meet the sufficiency requirements of the previous section and the standard given in this subsection. Second, to ensure optimal market enforcement, Nasdaq should also publish all company diversity data on its website, including non-adopting company explanations under the Diversity Inclusion Rule and every company’s data under the Diversity Matrix Rule, allowing all stakeholders to see and examine a company’s diversity policy.

As a controversial code built on ethical considerations, Nasdaq’s Diversity Inclusion Rule may likely fail to achieve early adoption.\textsuperscript{259} Because companies may not recognize controversial codes for economic value, resulting in more explanations than adopters,\textsuperscript{260} the Diversity Inclusion Rule will likely suffer from an absence of the social or “bandwagon effect” that is shown to lead to widespread adoption.\textsuperscript{261} Researchers that have identified this trend argue that additional forces are needed to implement a comply-or-explain code’s targeted

\begin{footnotesize}
  \item See Section IV.B.
  \item See Abma & Olaerts, supra note 195, at 288; Arcot et al., supra note 209, at 199.
  \item See Arcot et al., supra note 209, at 199; Mensi-Klarbach et al., supra note 170, at 579.
  \item See Arcot et al., supra note 209, at 199; Mensi-Klarbach et al., supra note 170, at 579.
\end{enumerate}
\end{footnotesize}
practice. Such additional forces implemented in foreign jurisdictions are monitoring committees, the threat of mandates from legislatures, and the use of targeted goals as opposed to vague goals. Nasdaq’s code is commendable on this front since its code already provides a specific target for companies: having two diverse board members according to its “[d]iverse” definition. Nasdaq’s Listing Qualifications Department also conducts monitoring to determine whether a company complies at all with its two new listing rules, and consequently reserves the right to delist a company that fails to disclose the diversity makeup of its board or an explanation if the company does not have two diverse board members. However, this Comment suggests that the Listing Qualifications Department not just assesses non-adopter company explanations under the three-part requirement given in the previous subsection but also rates companies that fail to give informative explanations in a low-quality group. Taking this extra step can give Nasdaq’s Diversity Inclusion Rule the fortitude it needs to achieve tangible impact by minimizing costs for market observers to assess explanations.

However, to assess and group low-quality explanations, a standard is needed to assess a company’s explanation beyond the three requirements given in the previous subsection. Such a standard should focus on materiality. The Supreme Court defined material information as information with “a substantial likelihood that a reasonable shareholder would consider it important in deciding how to vote” or “that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the ‘total mix’ of information” when an investor makes an investment decision. While the material standard largely leaves out any stakeholder interest beyond investors, it provides a minimum requirement with which companies are already familiar. Furthermore, a financially focused standard would incentivize companies to explain reasons for noncompliance in economic and corporate governance.

262 See id.
263 See Abma & Olaerts, supra note 195, at 298; Mensi-Klarbach et al., supra note 170, at 578–79.
265 Id. at 80490.
266 See Harper Ho, supra note 169, at 341.
268 See id.
terms, legitimizing the economic benefits of diversity in companies.\textsuperscript{269} In considering the economic benefits of boardroom diversity, regulated companies could begin to view the Rule beyond a code built on ethical considerations and thus accordingly alleviate the absence of bandwagon effects due to the possible lack of early adopters.\textsuperscript{270} By considering the economic and governance benefits, non-adopting companies would be further “nudge[d]” toward adopting the Diversity Inclusion Rule’s targeted practice.\textsuperscript{271}

To enforce such a standard, Nasdaq must first amend the Diversity Inclusion Rule to require that each company submit an explanation to the Listing Qualifications Department in advance of any upcoming shareholder meeting. The Listing Qualifications Department would assess the explanations for sufficiency under the three-part requirements and materiality, then tell companies of their status as either providing a low-quality explanation or not. Nasdaq would provide low-quality-explanation companies with time to alter their explanations to achieve a higher quality grade.

Second, Nasdaq should publish the explanations under the Diversity Inclusion Rule and the data under the Diversity Matrix Rule on the Nasdaq website. Publication of the Diversity Matrix Rule data and Diversity Inclusion Rule explanations would give all stakeholders a central location for companies’ boardroom diversity information. Since enforcement of comply-or-explain codes is theoretically in the hands of shareholders and potential shareholders, by publishing company information in a central location, Nasdaq would minimize the cost and effort required for shareholders to find and compare data of listed companies, thus ensuring a higher likelihood of active enforcement by shareholders. Furthermore, stakeholders, beyond just shareholders, could also access diversity data, who may not have access to proxy statements or information statements, nor consistently examine the websites of the more than 3,000 companies listed on the Nasdaq exchange. These stakeholders who are not invested or may be unable to invest in a company could easily access important diversity data of companies with whom they interact.\textsuperscript{272} Thus, market

\textsuperscript{269} See Harper Ho, supra note 169, at 341. But see George S. Georgiev, Too Big to Disclose: Firm Size and Materiality Blindspots in Securities Regulation, 64 UCLA L. Rev. 605, 625 (2017) (arguing that large firms can take advantage of the materiality standard to avoid disclosure of important information).

\textsuperscript{270} See Menisi-Klarbach et al., supra note 170, at 578.

\textsuperscript{271} See Felicia H.M. Liu, David Demeritt & Samuel Tang, Accounting for Sustainability in Asia: Stock Market Regulation and Reporting in Hong Kong and Singapore, 95 ECON. GEOGRAPHY 362, 366 (2019).

\textsuperscript{272} Touched on in Part III of this Comment, 42% of Americans do not invest in American stock markets.

enforcement would now include stakeholders who engage companies in ways beyond investing, such as retail purchases or giving recommendations to their networks. Publishing the information in a central location on Nasdaq’s website would also put companies at risk of losing reputational capital that can lead to further financial repercussions.\textsuperscript{273} Nasdaq currently publishes certain listed-company information on its website, including dividend history and SEC filings.\textsuperscript{274} Therefore, such a recommendation is not outlandish considering the number of companies listed on the exchange and current Nasdaq publications.\textsuperscript{275}

Finally, as part of this publishing effort, this Comment recommends that Nasdaq also give low-quality explanations in a collected group on its website, disclosing the companies that have failed to give sufficient, material explanations. Such a practice is commonly referred to as “naming and shaming,” and threatens companies that do not give sufficient explanations with the potential loss of reputation in the “Court of Public Opinion.”\textsuperscript{276} Again, for the same reasons that publishing diversity data under the Diversity Matrix Rule and all Diversity Inclusion Rule explanations of non-adopting companies provides all stakeholders a less costly method for researching and comparing listed companies, labelling companies that have refused to fully comply would inform stakeholders on firm attitudes towards diversity in an easy to understand and consolidated form. In addition, such a publication would increase incentives to adopt or give material information, allowing market enforcement to work optimally.\textsuperscript{277}

In sum, amending Nasdaq’s Diversity Inclusion Rule beyond enacting more stringent explanations includes incentivizing material information in explanations by nonadopters, monitoring for such material information in addition to the three-part requirements for explanation sufficiency, and enforcing material explanations through the publication and labeling of low-quality explanations. Publication of all reporting under the Diversity Inclusion Rule 5605(f)(2) and Diversity Matrix Rule 5606 would expand enforcement from shareholders to all stakeholders, thus increasing market enforcement and incentives for companies to adopt the codes’ targeted practice. Through heightened monitoring and publication, Nasdaq could avoid the known

\textsuperscript{273} See supra notes 64–67 and accompanying text.


\textsuperscript{275} See id.

\textsuperscript{276} See Abma & Olaerts, supra note 194, at 298–99.

\textsuperscript{277} Id. at 298.
weaknesses of comply-or-explain governance and achieve its goal to increase boardroom diversity in the companies listed on the Nasdaq exchange.

C. The Constitutional and Statutory Implications of the Proposed Amendments

While the amendments to Nasdaq’s Rules would result in a more stringent and potentially burdensome code for listed companies to follow, the arguments for its constitutional and statutory validity would largely remain the same as those that justify the current rule.\(^{278}\) In December of 2021, the Alliance for Fair Board Recruitment petitioned the Fifth Circuit to review the SEC’s approval Order.\(^{279}\) Later, seventeen state attorneys general filed an Amicus Brief in support of the Alliance for Fair Board Recruitment’s Petition for Review.\(^{280}\) The parties call for the Diversity Inclusion Rule to be overturned on constitutional and statutory grounds.\(^{281}\) Specifically, the Alliance for Fair Board Recruitment contends Nasdaq’s Rule is subject to constitutional scrutiny, fails that scrutiny, and the SEC’s Order is not in accordance with the 1934 Exchange Act.\(^{282}\) While this Comment’s focus is on the corporate governance efficacy of Nasdaq’s diversity rules, this section briefly responds to the statutory and constitutional arguments against the codes, highlighting how the proposed amendments to Nasdaq’s rules would not materially alter the SEC and Nasdaq’s response in the pending litigation.

\(^{278}\) See supra notes 151–58 and accompanying text.


\(^{281}\) Opening Brief for Petitioner at 51, All. for Fair Bd. Recruitment v. Sec. Exch. Comm’n, No. 21-60626 (5th Cir., Dec. 20, 2021). Oral arguments were held on August 28, 2022, in the Fifth Circuit, where the focus of the arguments was on whether the Nasdaq Diversity Inclusion Rule involved state action and whether the SEC exceeded its authority in approving the Rule. Cydney Posner, *Fifth Circuit Heats Oral Argument on Challenge to Nasdaq Board Diversity Rules—Will the Rules Survive?*, PUBCO (Sept. 8, 2022), https://www.jdsupra.com/legalnews/fifth-circuit-hears-oral-argument-on-8046591/. Attorneys for the petitioners argued that the Nasdaq rule was facially discriminatory and thus inconsistent with the 1934 Exchange Act as unconstitutional. Id. Whereas counsel for Nasdaq argued that SROs, like Nasdaq, are not and have historically been held to not be state actors. Id. Additionally, the SEC did not exceed its authority because it concluded that Nasdaq’s Diversity Inclusion Rule was consistent with the 1934 Exchange Act, compelling approval. Id. The judges who heard the case, according to one report, “sounded skeptical that the court should overturn the [Rule],” doubting the constitutional arguments presented by the petitioners. Id.

\(^{282}\) Posner, supra note 281.
1. Statutory Authority Under the 1934 Exchange Act

The listing rules and this Comment’s proposed amendments contemplate sections of the 1934 Exchange Act. According to Section 19(b) of the 1934 Exchange Act, the SEC “shall approve” an SRO proposal if the SEC finds it consistent with the 1934 Exchange Act’s requirements. In approving Nasdaq’s proposal, the SEC examined the 1934 Exchange Act’s Section 6(b), which governs the requirements for registering a national exchange. In particular, the SEC found the proposal in line with Section 6(b)(5), which requires the rules of national exchanges to be “designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, . . . to remove impediments to and perfect the mechanism of a free and open market and a national market system and, in general, to protect investors and the public interest,” and Section 6(b)(8), which requires that rules of national exchanges “not impose any burden on competition not necessary or appropriate.”

This Comment’s proposed amendments would not push the Diversity Inclusion Rule outside the purview of the 1934 Exchange Act. For one, the Rule would increase disclosures and information to the public and, thus, “prevent fraudulent and manipulative acts and practices.” Also, the benefits of a diverse boardroom, which would result from a more stringent Diversity Inclusion Rule, have been shown to protect investors and is in the public interest. Therefore, the current SEC would likely approve such an amended rule under section 19(b) of the 1934 Exchange Act under the same reasoning it approved the current Diversity Inclusion Rule.

2. Constitutional Issues Remain the Same Under the Proposed Amendments

The Diversity Inclusion Rule as it stands hinges on whether a court finds Nasdaq, as an SRO, to be a state actor. If the SRO is deemed a state actor, Nasdaq would be subject to constitutional imperatives that would not apply if it were merely a private actor. As argued in the Alliance for Fair Board Recruitment’s

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284 Id.
Opening Brief, such a finding would call for heightened scrutiny under the Fifth Amendment and even potentially the First Amendment. Currently, there is a circuit split with varying opinions on whether SROs like Nasdaq are considered state actors. Assessing the merits of either side of the argument is beyond the scope of this Comment. However, what is important is that this Comment’s proposed amendments would not change the analysis under any classification of state action theory.

Important to whether Nasdaq would be ruled a state actor in all circuit tests is the interplay between Nasdaq and the government. More specifically, these tests concern the level of involvement of the state—in this case, the SEC. Under the proposed amendments, the SEC would have no more involvement than under the current Rule. The new amendments only require more oversight and involvement of Nasdaq, the SRO in the equation—not the state. Therefore, these amendments would not interfere with any prospective or ongoing litigation.

CONCLUSION

Nasdaq’s Rules 5605(f)(2) and 5606 represent commendable and exciting advances in the influence of ESG issues in American corporate governance. The rules inventively thread the needle between a mandated disclosure requirement, board representation quota, and a soft-law, flexible regulation that will likely result in increased boardroom representation. While largely misinterpreted in the public and media, Nasdaq’s Rule 5605(f)(2), or Diversity Inclusion Rule, set forth a comply-or-explain model of governance that sought to allow companies to either have a diverse board or explain why they were unable to. In promulgating the Rule, Nasdaq, perhaps afraid of listed-company backlash, prioritized flexibility over effectiveness. Unfortunately, such flexibility created gaps identifiable through research of the comply-or-explain governance regimes more widely used abroad.

This Comment offered solutions that Nasdaq could take to amend its current rules to ensure broader market enforcement beyond investor considerations. The

290 See id. at 1182–86.
291 See id.
292 Posner, supra note 281.
amendments proposed here rely on increasing the publicity of disclosures under both Rules 5605(f)(2) and 5606, more requirements for explainers under Rule 5605(f)(2) who fail to have two diverse board members, and increased Nasdaq monitoring and assessment of explanations. The proposed amendments’ goal is to provide all stakeholders with the ability to force slow-to-adopt companies to either give material explanations or nominate two diverse board members.

Important to the success of any ESG-focused regulation is the perceived economic benefit of the code beyond just the political or ethical considerations. Above all, this Comment hopes to provide a survey of the benefits that diverse board members bring to any company and why steps like those taken by Nasdaq, whether flawed or not, benefit American markets and represent the future.

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