

2023

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

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Recommended Citation

Johnson A. Salisbury Jr., *To Have or Have Not: The Limits of Comply-or-Explain Governance in an American Exchange*, 72 Emory L. J. 1485 (2023).

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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.¹ In the wake of the past two elections and the killing of George Floyd, many American citizens reevaluated their understanding of American institutions.² One such institution that has been widely brought under scrutiny is the corporation.³ An obvious and immediate area of the corporation that regulators have looked to is the boardroom.⁴ 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.⁵ 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.⁶

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.⁷ While some of these state enactments face growing opposition through

¹ See Larry Buchanan, Quoc Trung Bui & Jugal K. Patel, *Black Lives Matter May Be the Largest Movement in U.S. History*, N.Y. TIMES (July 3, 2020), <https://www.nytimes.com/interactive/2020/07/03/us/george-floyd-protests-crowd-size.html>.

² See *id.* (explaining that millions of people protested during the Black Lives Matter demonstrations in 2020 and the Women's March in 2017).

³ See, e.g., Adam O. Emmerich, David M. Silk & Sebastian V. Niles, *Using ESG Tools to Help Combat Systemic Racism and Injustice*, HARV. L. SCH. F. ON CORP. GOVERNANCE (June 17, 2020), <https://corpgov.law.harvard.edu/2020/06/17/using-esg-tools-to-help-combat-systemic-racism-and-injustice/>.

⁴ See Simran Jeet Singh, *Boards Need Real Diversity, Not Tokenism*, HARV. BUS. REV. (Aug. 31, 2021), <https://hbr.org/2021/08/boards-need-real-diversity-not-tokenism>.

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.”).

⁶ See Kathy Gurchiek, *Report: Diversity on Boards Growing Slowly but Steadily*, SHRM (June 13, 2019), <https://www.shrm.org/resourcesandtools/hr-topics/behavioral-competencies/global-and-cultural-effectiveness/pages/report-diversity-on-boards-growing-slowly-but-steadily.aspx>. For instance, at Russell 3000 companies in 2019, women held 19% of all board seats, compared with 12% in 2008. Subodh Mishra, *U.S. Board Diversity Trends in 2019*, HARV. L. SCH. F. ON CORP. GOVERNANCE (June 18, 2019), <https://corpgov.law.harvard.edu/2019/06/18/u-s-board-diversity-trends-in-2019/> (examining the boards of 2,175 Russell 3000 companies including the boards of 401 members of the S&P 500 with a general meeting of shareholders in 2019). However, underrepresented minorities held only about 10% of board seats at Russell 3000 companies in 2019. *Id.*

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,⁸ other non-governmental regulatory entities have enacted their own rules to increase corporate board diversity.⁹ As a Self-Regulatory Organization (“SRO”) subject to the requirements of the Securities Exchange Act of 1934 (“1934 Exchange Act”),¹⁰ 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 2020.¹¹ 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”).¹² The two diverse directors must include at least one female and at least one other underrepresented minority or LGBTQ+ individual.¹³ 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”).¹⁴ On August 6, 2021, the SEC approved Nasdaq’s Diversity Inclusion Rule and Diversity Matrix Rule,¹⁵ finding the rules consistent with the requirements of the 1934 Exchange Act.¹⁶

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

Huber & Maj Vaseghi, *California Gender Board Diversity Law Is Held Unconstitutional*, HARV. L. SCH. F. ON CORP. GOVERNANCE (June 12, 2022), <https://corpgov.law.harvard.edu/2022/06/12/california-gender-board-diversity-law-is-held-unconstitutional/>.

⁸ See Fortt et al., *supra* note 7.

⁹ Cydney Posner, *SEC Approves Nasdaq “Comply-or-Explain” Proposal for Board Diversity*, HARV. L. SCH. F. ON CORP. GOVERNANCE (Aug. 26, 2021), <https://corpgov.law.harvard.edu/2021/08/26/sec-approves-nasdaq-comply-or-explain-proposal-for-board-diversity/>.

¹⁰ 15 U.S.C. § 78s(b)(1).

¹¹ See Self-Regulatory Organizations, Exchange Act Release No. 34-90574, 85 Fed. Reg. 80472 (Dec. 4, 2020).

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 Self-Regulatory Organizations, Exchange Act Release No. 34-92590, 86 Fed. Reg. 44424, 44425 (Aug. 6, 2021).

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.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.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.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.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.”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.*

²⁰ AARON A. DHIR, *CHALLENGING BOARDROOM HOMOGENEITY: CORPORATE LAW, GOVERNANCE, AND DIVERSITY* 240 (2015).

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.²² 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.”²³ While directors delegate a corporation's management to various officers,²⁴ directors still perform essential functions in the corporation

²² See Lucian A. Bebchuk, *The Myth of the Shareholder Franchise*, 93 VA. L. REV. 675, 679 (2007).

²³ DEL. CODE ANN. tit. 8, § 141(a) (2020). Delaware law is supremely important in corporate law, with 66.8% of all Fortune 500 corporations and 93% of U.S.-based Initial Public Offerings registered in the state in 2021. *Annual Report Statistics*, DEL. DIV. OF CORP., <https://corp.delaware.gov/stats/> (last visited Jan. 29, 2023).

²⁴ DHIR, *supra* note 20, at 30.

in addition to their monitoring and advising roles.²⁵ Directors select senior officers of the corporation, including the CEO.²⁶ After selecting corporate officers, directors set the officers' compensation, thus controlling management incentives.²⁷ Finally, directors make fundamental corporate decisions that can have larger ramifications beyond the corporation.²⁸

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[.]”²⁹ 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.³⁰ Researchers attributed this finding to “gender spillovers from board members to executives.”³¹ 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.³²

Another reason scholars and economists identify diversity in the boardroom as an important step toward a more diverse corporate culture is “signaling theory.”³³ From the notion of asymmetric information, signaling theory

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.

³⁰ Matsa & Miller, *supra* note 29, at 635, 639; *see also* LOIS JOY, ADVANCING WOMEN LEADERS: THE CONNECTION BETWEEN WOMEN BOARD DIRECTORS AND WOMEN CORPORATE OFFICERS 3 (2008), https://www.catalyst.org/wp-content/uploads/2019/01/Advancing_Women_Leaders_The_Connection_Between_Women_Board_Directors_and_Women_Corporate_Officers_0.pdf (finding a positive correlation between the percentage of female directors and the percentage of female corporate officers); Michael Barbaro, *As a Director, Clinton Moved Walmart Board, but Only So Far*, N.Y. TIMES (May 20, 2007), <https://www.nytimes.com/2007/05/20/us/politics/20walmart.html>.

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.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.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.³⁶ For instance, diverse directors send “credible signals of the absence of a glass ceiling” within the organization.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.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

³⁴ Lissa Lamkin Broome & Kimberly D. Krawiec, *Signaling Through Board Diversity: Is Anyone Listening?*, 77 U. CIN. L. REV. 431, 447 (2008).

³⁵ See DHIR, *supra* note 20, at 33. *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).

³⁶ See DHIR, *supra* note 20, at 49.

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.”).

³⁸ See Self-Regulatory Organizations, Exchange Act Release No. 34-90574, 85 Fed. Reg. 80472, 80472–74 (Dec. 4, 2020).

directors and shareholder value.³⁹ 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.⁴⁰ 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.

⁴⁰ See JASON M. THOMAS & MEGAN STARR, GLOBAL INSIGHTS: FROM IMPACT INVESTING TO INVESTING FOR IMPACT 5 fig.5 & n.19, https://www.carlyle.com/sites/default/files/2020-02/From%20Impact%20Investing%20to%20Investing%20for%20Impact_022420.pdf (last visited Jan. 28, 2023) (defining diverse as female, Black, Hispanic, or Asian); Securities Exchange Act Release No. 34-90574, 85 Fed. Reg. 80472, 80475 (Dec. 4, 2020).

⁴¹ See THOMAS & STARR, *supra* note 40, at 5 & n.19 (defining diverse as female, Black, Hispanic, or Asian).

⁴² See MCKINSEY & CO., DIVERSITY WINS: HOW INCLUSION MATTERS 13 (May 2020), <https://www.mckinsey.com/featured-insights/diversity-and-inclusion/diversity-wins-how-inclusion-matters>.

⁴³ CREDIT SUISSE, THE CS GENDER 3000: WOMEN IN SENIOR MANAGEMENT 16 (Sept. 14, 2014), <https://www.calpers.ca.gov/docs/diversity-forum-credit-suisse-report-2015.pdf>.

⁴⁴ See MEGAN THWING EASTMAN, DAMION RALLIS, & GAIA MAZZUCHELLI, THE TIPPING POINT: WOMEN ON BOARDS AND FINANCIAL PERFORMANCE 7 (Dec. 2016), <https://www.msci.com/documents/10199/fd1f8228-cc07-4789-acee-3f9ed97ee8bb>.

⁴⁵ See OUT LEADERSHIP, LGBTQ+ VISIBILITY COUNTS: BOARD DEMOGRAPHICS REPORTING GUIDELINES 2 (June 2022), <https://outleadership.com/content/uploads/2019/01/OL-LGBT-Board-Diversity-Guidelines.pdf>.

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.⁴⁶ One such study found that female directors are more likely to sit on the audit committee of their corporation,⁴⁷ which, importantly, is associated with improved financial reporting discipline, leading to increased investor confidence in financial statements.⁴⁸ 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.⁴⁹ 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.⁵⁰

Outside of the audit committee, another study concluded that gender-diverse boards are associated with lower rates of financial reporting errors and fraud.⁵¹ Moreover, direct evidence found that diverse boards are more likely to hold CEOs and other executives accountable, further reducing the chances of fraud.⁵² 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.

⁴⁶ See Self-Regulatory Organizations, Exchange Act Release No. 34-90574, 85 Fed. Reg. 80472, 80477 (Dec. 4, 2020).

⁴⁷ See Renée B. Adams & Daniel Ferreira, *Women in the Boardroom and Their Impact on Governance and Performance*, 94 J. FIN. ECON. 291, 292 (2009).

⁴⁸ Bin Srinidhi, Ferdinand A. Gul & Judy Tsui, *Female Directors and Earnings Quality*, 28 CONTEMP. ACCT. RSCH. 1610, 1612–14 (2011).

⁴⁹ Maria Consuelo Pucheta-Martínez, Inmaculada Bel-Oms & Gustau Olcina-Sempere, *Corporate Governance, Female Directors and Quality of Financial Information*, 25 BUS. ETHICS: EUR. REV. 363, 378 (2016).

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.”⁵³ 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.”⁵⁴ 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.⁵⁵ These characteristics of heterogeneous groups are consistent in diversely composed boards,⁵⁶ 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.⁵⁷

Eliminating groupthink is especially significant given the gravity of a board’s role in a corporation.⁵⁸ 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.”⁵⁹ 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

⁵³ See Lynne L. Dallas, *The New Managerialism and Diversity on Corporate Boards of Directors*, 76 TUL. L. REV. 1363, 1391, 1393 (2002).

⁵⁴ Daniel P. Forbes & Frances J. Milliken, *Cognition and Corporate Governance: Understanding Boards of Directors as Strategic Decision-Making Groups*, 24 ACAD. MGMT. REV. 489, 496 (1999).

⁵⁵ Dallas, *supra* note 53, at 1391.

⁵⁶ *See id.*

⁵⁷ See Gennaro Bernile, Vineet Bhaqwat & Scott Yonker, *Board Diversity, Firm Risk, and Corporate Policies*, 127 J. FIN. ECON. 588, 608 (2017).

⁵⁸ See Bebchuk, *supra* note 22, at 679; DHIR, *supra* note 20, at 230.

⁵⁹ See Self-Regulatory Organizations, Exchange Act Release No. 34-90574, 85 Fed. Reg. 80472, 80479–80 (Dec. 4, 2020).

studies have only found a correlation and not causation.⁶⁰ 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.⁶¹ 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.⁶² Furthermore, scholars have argued that it is possible there are not enough diverse directors to “show consistent positive impact in empirical studies.”⁶³

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.⁶⁴ 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.⁶⁵ 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.⁶⁶ 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

⁶⁰ See, e.g., Jesse M. Fried, *Will Nasdaq’s Diversity Rules Harm Investors?* 2–3 (Eur. Corp. Governance Inst., Law Working Paper No. 579/2021, 2021), <https://ssrn.com/abstract=3812642>.

⁶¹ See Deborah L. Rhode & Amanda K. Packel, *Diversity on Corporate Boards: How Much Difference Does Difference Make?*, 39 DEL. J. CORP. L. 377, 387 (2014).

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

⁶³ Amanda K. Packel, *Government Intervention into Board Composition: Gender Quotas in Norway and Diversity Disclosures in the United States*, 21 STAN. J. L. BUS. & FIN. 192, 202 (2016) (reviewing AARON A. DHIR, *CHALLENGING BOARDROOM HOMOGENEITY: CORPORATE LAW, GOVERNANCE, AND DIVERSITY* (2015)).

⁶⁴ See *supra* notes 34–37 and accompanying text.

⁶⁵ See, e.g., Tonya Garcia, *Starbucks Says Racial Bias Incident Delayed Its Marketing Push, Hurt Same-Store Sales*, MARKETWATCH (June 21, 2018, 8:20 AM), <https://www.marketwatch.com/story/starbucks-saysracial-bias-incident-delayed-its-marketing-push-hurt-same-store-sales-2018-0620>.

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.⁶⁷ ESG success is also a tool in attracting top talent among younger workers.⁶⁸ As stakeholder views of ESG continue to progress, evidence suggests that companies that fail to keep up can suffer.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.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.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.⁷² However, women are still disproportionately underrepresented compared to their 50.2% share of the U.S. population.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.⁷⁴

⁶⁷ Beat Reber, Agnes Gold & Stefa Gold, *ESG Disclosure and Idiosyncratic Risk in Initial Public Offerings*, 179 J. BUS. ETHICS 867, 883 (2022).

⁶⁸ See *Over 86% of Job Seekers Say Workplace Diversity Is an Important Factor When Looking for Job*, NEWSWIRE (Nov. 25, 2019, 11:00 AM), <https://www.prnewswire.com/news-releases/over-86-of-job-seekers-say-workplacdiversity-is-an-important-factor-when-looking-for-a-job-300964115.html>.

⁶⁹ See, e.g., Garcia, *supra* note 65.

⁷⁰ See Peter Eavis, *Diversity Push Barely Budes Corporate Boards to 12.5%, Study Finds*, N.Y. TIMES, <https://www.nytimes.com/2020/09/15/business/economy/corporate-boards-black-hispanic-directors.html> (Sept. 7, 2021).

⁷¹ *Id.*

⁷² *Women on Corporate Boards (Quick Take)*, CATALYST (Nov. 5, 2021), <https://www.catalyst.org/research/women-on-corporate-boards/>.

⁷³ Chris Brummer & Leo E. Strine, Jr., *Duty and Diversity*, 75 VAND. L. REV. 1, 12 (2022).

⁷⁴ U.S. GOV'T ACCOUNTABILITY OFF., *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 DHIR, *supra* note 20, at 49.

⁸⁰ *Id.*

⁸¹ Ashleigh Shelby Rosette, Geoffrey J. Leonardelli & Katherine W. Phillips, *The White Standard: Racial Bias in Leader Categorization*, 93 J. APPLIED PSYCH. 758, 760 (2008).

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

⁸² Frank Dobbin & Jiwook Jung, *Corporate Board Gender Diversity and Stock Performance: The Competence Gap or Institutional Investor Bias?*, 89 N.C. L. REV. 809, 835 (2011).

⁸³ See DELOITTE & SOC’Y FOR CORP. GOVERNANCE, BOARD PRACTICES REPORT: COMMON THREADS ACROSS BOARDROOMS 5 (2018), https://higherlogicdownload.s3.amazonaws.com/GOVERNANCEPROFESSIONALS/a8892c7c-6297-4149-b9fc-378577d0b150/UploadedImages/1202241_2018_Board_Practices_Report_FINAL.pdf.

⁸⁴ DHIR, *supra* note 20, at 11, 53.

⁸⁵ J. Yo-Jud Cheng, Boris Groysberg & Paul M. Healy, *Why Do Boards Have So Few Black Directors?*, HARV. BUS. REV. (Aug. 13, 2020), <https://hbr.org/2020/08/why-do-boards-have-so-few-black-directors>.

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.⁸⁶ Accordingly, the SEC began promulgating rules to increase disclosure requirements to give investors more meaningful information related to director voting.⁸⁷ In a proposed amendment under the 1934 Exchange Act, the SEC requested comments on requiring board nominating committees to consider diversity.⁸⁸ 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.⁸⁹ 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.⁹⁰ The SEC decided not to define diversity but instead allowed firms "to define diversity in ways they consider appropriate."⁹¹ 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.⁹²

Currently, the SEC does not require board composition disclosures; however, many companies have begun to do so.⁹³ For instance, in 2019, forty-

⁸⁶ Mary Jo White, Chair, SEC, Speech at The Economic Club of New York: The SEC After the Financial Crisis: Protecting Investors, Preserving Markets (Jan. 17, 2017) (transcript available at https://www.sec.gov/news/speech/the-sec-after-the-financial-crisis.html#_ftnref14).

⁸⁷ Proxy Disclosure Enhancements, Exchange Act Release No. 33-9089, 74 Fed. Reg. 68334, 68334 (Dec. 16, 2009).

⁸⁸ *Id.* at 68343.

⁸⁹ *Id.*; see also DHIR, *supra* note 20, at 176.

⁹⁰ Proxy Disclosure Enhancements, Exchange Act Release No. 33-9089, 74 Fed. Reg. at 68343-44. Unlike Nasdaq's Diversity Inclusion Rule, this is not a comply-or-explain governance model. See Self-Regulatory Organizations, Exchange Act Release No. 34-90574, 85 Fed. Reg. 80472, 80488 (Dec. 4, 2020).

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.⁹⁴ While the number of disclosures regarding board diversity is high among the largest corporations, the corporate boardroom remains largely homogenous,⁹⁵ 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.⁹⁶ 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.⁹⁷ However, in a country generally against quotas,⁹⁸ an American regulatory entity is highly unlikely to adopt the hard quota models like those found abroad.⁹⁹ 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.¹⁰⁰

⁹⁴ See Cydney Posner, *Will Companies Accede to Calls for Actions to Improve Racial and Ethnic Diversity in Hiring and Promotion? California Considers a New Mandate for Racial/Ethnic Board Diversity*, COOLEY PUBCO (July 15, 2020), <https://cooleypubco.com/2020/07/15/calls-for-actions-racial-ethnic-diversity/> (discussing a report finding that "45% of companies in the Fortune 100 disclosed statistics on board racial/ethnic composition" in 2019).

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.*

⁹⁶ Allison Herren Lee, Comm'r, SEC, Remarks at the Council of Institutional Investors Fall 2020 Conference: Diversity Matters, Disclosure Works, and the SEC Can Do More (Sep. 22, 2020) (transcript available at https://www.sec.gov/news/speech/lee-cii-2020-conference-20200922#_ftn23).

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).

⁹⁸ Darren Rosenblum, *Carrots and Sticks: Why Nasdaq Adopted Its Radical Board Diversity Rule*, FORBES (Dec. 2, 2020, 9:45 AM), <https://www.forbes.com/sites/darrenrosenblum/2020/12/02/carrots-and-sticks-why-nasdaq-adopted-its-radical-board-diversity-quota/?sh=3493d243b571>.

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/#1>. 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.¹⁰¹ 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).¹⁰² 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."¹⁰³ The Board Diversity Matrix is a disclosure form comparable to the EEOC's EEO-1 form.¹⁰⁴ The Matrix allows companies to give statistical data on the diversity composition of their board in a consistent format to other companies.¹⁰⁵ According to Nasdaq, the Diversity Matrix Rule gives "stakeholders" consistent, comparable disclosure of board diversity data.¹⁰⁶ This consistency comes from its uniform definition of diversity that applies to all subjected companies.¹⁰⁷ 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.¹⁰⁸

population"); Caroline Crenshaw, Comm'r, SEC, Statement on the "Modernization" of Regulations S-K Items 101, 103, and 105 (Aug. 26, 2020) (transcript available at <https://www.sec.gov/news/public-statement/crenshaw-statement-modernization-regulation-s-k>). Current SEC Chair Gary Gensler said at his confirmation hearing that along with climate disclosures, workforce diversity disclosures is an area of importance and potential SEC regulation. See Chris Matthews, *Gary Gensler Signals Support for Climate, Workforce Diversity Disclosure Requirements in Confirmation Hearings*, MARKETWATCH, <https://www.marketwatch.com/story/gary-gensler-signals-support-for-climate-workforce-diversity-disclosure-requirements-in-confirmation-hearings-11614703374> (Mar. 2, 2021, 2:21 PM). The SEC also indicated in its Spring 2021 regulatory agenda that the agency is considering recommending proposed rule amendments to enhance registrant disclosures on the diversity makeup of corporate boards. See Hudson, *supra*. In addition, President Biden signed the Executive Order on Diversity, Equity, Inclusion, and Accessibility in the Federal Workforce on June 25, 2021, which promotes the inclusion of diverse members in the federal government, including employees who identify as LGBTQ+ and disabled. Exec. Order No. 14,035, 86 Fed. Reg. 34593, 34594 (June 30, 2021).

¹⁰¹ Self-Regulatory Organizations, Exchange Act Release No. 34-90574, 85 Fed. Reg. 80472 (Dec. 4, 2020). Section 19(b) of the 1934 Exchange Act governs the promulgation of rules by covered SROs. 15 U.S.C. 78s(b)(1). Nasdaq filed its proposal using SEC Form 19b-4, which is used by SROs to inform the SEC of any proposed rule change pursuant to Rule 19(b)(4). 17 CFR 240.19b-4.

¹⁰² Self-Regulatory Organizations, Exchange Act Release No. 34-90574, 85 Fed. Reg. at 80486.

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.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”).¹¹⁰ The Diversity Matrix Rule also allows directors to leave their racial, sexual orientation, and gender identities “[u]ndisclosed.”¹¹¹

Nasdaq allows companies the flexibility to provide the statistical disclosure in either a proxy statement, information statement, or on the company’s website.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.¹¹³ Next, Nasdaq assesses the plan and gives the company 180 days to regain compliance.¹¹⁴ Finally, if the company does not regain compliance within that timeframe, Nasdaq will delist the company from the exchange, subject to appeal.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.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

¹⁰⁹ *Id.*

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 *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.*

¹¹¹ *Id.* at 80486.

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.*

¹¹³ *Id.* at 80488.

¹¹⁴ *Id.*

¹¹⁵ *Id.*

¹¹⁶ *Id.*

minority or LGBTQ+ person.¹¹⁷ 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.¹¹⁸ The definition of diversity applicable to the Diversity Matrix Rule disclosure requirement also applies to the Diversity Inclusion Rule.¹¹⁹ 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.¹²⁰

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.¹²¹ Nasdaq clarifies in its proposal that it will not assess the quality of the explanation of a non-adopting company.¹²² 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.¹²³ If the company does not cure the deficiency in the specified amount of time, Nasdaq will delist the company, subject to appeal.¹²⁴

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.¹²⁵ 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.¹²⁶ 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

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.

¹¹⁹ *See supra* notes 108–10 and accompanying text; Self-Regulatory Organizations, Exchange Act Release No. 34-90574, 85 Fed. Reg. at 80488.

¹²⁰ Self-Regulatory Organizations, Exchange Act Release No. 34-90574, 85 Fed. Reg. at 80486.

¹²¹ *Id.* at 80488.

¹²² *Id.*

¹²³ *Id.* at 80490.

¹²⁴ *Id.*

¹²⁵ *See id.* at 80493.

¹²⁶ *See id.* at 80486.

diversity.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.”¹²⁸ Stakeholder governance has become a larger part of today's corporate law discussion.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.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.¹³¹ Instead, stakeholder governance focuses on all stakeholders and the impacts a corporation may have beyond investor returns.¹³² As evidenced by the language in its proposal to the SEC, Nasdaq appears to adhere to this stakeholder-focused view.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.¹³⁴ Yet, as an SRO, Nasdaq has successfully implemented reform, insulated from any corporate captured political obstructionism.¹³⁵

¹²⁷ See *id.* at 80486, 80493.

¹²⁸ *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.” *Stakeholder*, BLACK'S LAW DICTIONARY (11th ed. 2019).

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

¹³⁰ 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)), 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)).

¹³¹ See Strine, *supra*, note 129, at 399–401.

¹³² See *id.*

¹³³ See Self-Regulatory Organizations, Exchange Act Release No. 34-90574, 85 Fed. Reg. at 80472.

¹³⁴ See Strine, *supra* note 129, at 421–23; 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).

¹³⁵ See Self-Regulatory Organizations, Exchange Act Release No. 34-90574, 85 Fed. Reg. 80472 (proposing rules to increase board diversity and improve stakeholder outcomes).

Nasdaq's proposal also highlights its use of comply-or-explain as a model of corporate governance regulation with its Diversity Inclusion Rule.¹³⁶ Comply-or-explain governance is a soft form of corporate governance regulation due to its self-regulation principles.¹³⁷ 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.¹³⁸ However, Nasdaq takes a fairly different approach by mandating disclosure through the Diversity Matrix Rule regardless of whether a company complies or explains.¹³⁹ Also, Nasdaq makes the "comply" of its Diversity Inclusion Rule a targeted quota instead of disclosure.¹⁴⁰ This approach elevates Nasdaq's Diversity Inclusion Rule from a softer governance code to a more moderate one.¹⁴¹ 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.¹⁴² For instance, Nasdaq's only requirement is to explain that the company is subject to Rule 5605(f)(2).¹⁴³ After that, the company can explain why it has failed to comply with the Rule for any reason it sees fit.¹⁴⁴ 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.¹⁴⁵ 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.¹⁴⁶ 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

¹³⁶ *Id.* at 80488.

¹³⁷ *See* Rosenblum, *supra* note 97, at 185 fig.9.1.

¹³⁸ *See id.* at 185 & fig.9.1.

¹³⁹ Self-Regulatory Organizations, Exchange Act Release No. 34-90574, 85 Fed. Reg. at 80486.

¹⁴⁰ *See id.* at 80488.

¹⁴¹ *See* Rosenblum, *supra* note 97, at 185 fig.9.1.

¹⁴² Self-Regulatory Organizations, Exchange Act Release No. 34-90574, 85 Fed. Reg. at 80488.

¹⁴³ *Id.*

¹⁴⁴ *See id.* at 80502.

¹⁴⁵ *See id.*

¹⁴⁶ *See id.*

advantage of the flexibility Nasdaq allows for in its Diversity Inclusion Rule and Diversity Matrix Rule.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, 2020.¹⁴⁸ The proposal received over 200 comments, with a majority supporting the proposal.¹⁴⁹ Among the supporting comments, many argued that Nasdaq's proposal improves corporate governance, creates transparency, advances board diversity, and heightens corporate performance.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.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.¹⁵² By definition, independent or outside directors, Nasdaq explained, are not company employees and thus not subject to Title VII.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

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. DHR, *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.

¹⁴⁸ Self-Regulatory Organizations, Exchange Act Release No. 34-90574, 85 Fed. Reg. 80472.

¹⁴⁹ Letter from John A. Zecca, Chief Legal Off. & Chief Regul. Off., The Nasdaq Stock Market LLC, to Vanessa Countryman, U.S. Sec. & Exch. Comm'n 1-2 (Feb. 26, 2021) [hereinafter Letter from Zecca], <https://www.sec.gov/comments/sr-nasdaq-2020-081/srnasdaq2020081-8425992-229601.pdf>.

¹⁵⁰ *Id.* at 2.

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>.

¹⁵² Email from Kastenberg, *supra* note 151, at 1-2.

¹⁵³ *Id.* at 6.

objective of two diverse directors and comply with Title VII.¹⁵⁴ 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.¹⁵⁵ In addition, Nasdaq argued its proposed rules are not “fairly attributable” to the state, which, if so, would subject Nasdaq to constitutional standards.¹⁵⁶ Commenters also raised constitutional privacy issues regarding the self-identification aspect of the Diversity Matrix Rule.¹⁵⁷ 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.¹⁵⁸ 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.¹⁵⁹

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.¹⁶⁰ 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.¹⁶¹ 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).¹⁶² 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.

¹⁵⁸ *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.

¹⁵⁹ *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.

¹⁶⁰ *See id.* at 7.

¹⁶¹ Letter from Zucca, *supra* note 149, at 7.

¹⁶² *Id.*

philosophy as the company determines.”¹⁶³ 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.”¹⁶⁴

Following Nasdaq’s responses to comments, the SEC Commissioners voted along party lines to approve Nasdaq’s proposal in August of 2021.¹⁶⁵ SEC Chair Gary Gensler and Commissioners Herren Lee and Caroline Crenshaw voted in favor of the proposal.¹⁶⁶ The remaining Commissioners, Elad Roisman and Hester Peirce, voted against the proposal.¹⁶⁷ 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.¹⁶⁸

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.*

¹⁶⁸ Self-Regulatory Organizations, Exchange Act Release No. 92590, 86 Fed. Reg. 44424, 44424 (Aug. 6, 2021).

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.¹⁶⁹ Since 1992, the governance model has spread throughout the world, most prevalently in Europe.¹⁷⁰ Early codes, such as the code implemented in the United Kingdom, responded to business scandals of financial mismanagement.¹⁷¹ However, increasingly, "codes of good governance," as they are sometimes referred to abroad, have included more aspirational, nonfinancial goals, including ESG reporting.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."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.¹⁷⁴ Therefore, a firm is non-compliant if it both fails to implement the code's best practices and fails to explain why.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.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-

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>.

¹⁷⁰ *See* Virginia Harper Ho, "Comply or Explain" and the Future of Nonfinancial Reporting, 21 LEWIS & CLARK L. REV. 317, 320 (2017).

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

¹⁷² *Id.*; *see also* Harper Ho, *supra* note 170, at 321–22.

¹⁷³ Harper Ho, *supra* note 170, at 321.

¹⁷⁴ *Id.*

¹⁷⁵ *Id.*

¹⁷⁶ *Id.*

or-explain regimes.¹⁷⁷ When a firm complies by explaining its non-adoption, enforcement occurs through shareholders assessing the adequacy of the company's explanation.¹⁷⁸ With their assessment, shareholders may see a company's shares as more or less appealing.¹⁷⁹ Therefore, the market serves as the true enforcer, theoretically reflecting the quality of a firm's compliance with the code.¹⁸⁰ Thus, comply-or-explain is a disclosure-based method of governance, giving relevant information to shareholders.¹⁸¹ Essential to this equation, however, is the availability of the information to shareholders.¹⁸² Therefore, regulators generally require companies to disclose their statement of compliance or explanation of non-adoption in state-required disclosures or proxy statements.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.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.¹⁸⁵

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

¹⁷⁷ Keay, *supra* note 17, at 282.

¹⁷⁸ *Id.* at 280.

¹⁷⁹ *Id.* at 282.

¹⁸⁰ *Id.* at 282–83.

¹⁸¹ Konstantinos Sergakis, *EU Corporate Governance: A Supervisory Mechanism for the 'Comply or Explain' Principle?*, 10 EUR. CO. & FIN. L. REV. 394, 395 (2013).

¹⁸² See Harper Ho, *supra* note 170, at 329.

¹⁸³ *Id.*

¹⁸⁴ *Id.* at 330.

¹⁸⁵ *Id.*

¹⁸⁶ Self-Regulatory Organizations, Exchange Act Release No. 34-90574, 85 Fed. Reg. 80472, 80492 (Dec. 4, 2020).

¹⁸⁷ *Id.*

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 controversiality 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

¹⁸⁹ See *id.* at 80488; see Harper Ho, *supra* note 170, at 331–39.

¹⁹⁰ See Self-Regulatory Organizations, Exchange Act Release No. 34-90574, 85 Fed. Reg. at 80497.

¹⁹¹ Harper Ho, *supra* note 170, at 332.

¹⁹² *Id.* at 321.

¹⁹³ See Self-Regulatory Organizations, Exchange Act Release No. 34-90574, 85 Fed. Reg. at 80488.

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.¹⁹⁶ 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.¹⁹⁷ In the United Kingdom, where comply-or-explain codes originated, institutional investors like hedge funds were seen as viable enforcers of such early codes.¹⁹⁸ 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.¹⁹⁹

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.²⁰⁰ 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.²⁰¹ 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.²⁰²

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.²⁰³ 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

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.

²⁰⁰ Jeff Cox, *Passive Investing Automatically Tracking Indexes Now Controls Nearly Half the US Stock Market*, CNBC, <https://www.cnbc.com/2019/03/19/passive-investing-now-controls-nearly-half-the-us-stock-market.html> (Mar. 19, 2019, 5:56 PM).

²⁰¹ *Id.* With much lower costs than actively managed funds like hedge funds, ETFs and passively managed funds are popular for average investors who are not playing the stock market. *Id.*

²⁰² See Justin Kuepper, *What Are the Major World Stock Market Indexes?*, BALANCE, <https://www.thebalancemoney.com/major-world-stock-market-indexes-4148491#:~:text=Global%20Stock%20Market%20Indexes,-Global%20stock%20market&text=S%26P%20Global%20Index,Dow%20Jones%20Global%20Titans%2050> (Mar. 6, 2022). See generally Todd Shriber, *3 ETF's Following Nasdaq Indexes to Add to Your 2022 Watchlist*, NASDAQ (Dec 31, 2021, 9:13 AM), <https://www.nasdaq.com/articles/3-etfs-following-nasdaq-indexes-to-add-to-your-2022-watchlist> (listing three major Nasdaq Composite ETFs that track and invest in each of the 3,000-plus securities listed on the Nasdaq Stock Exchange).

²⁰³ Opinion, Farhad Manjoo, *What BlackRock, Vanguard and State Street Are Doing to the Economy*, N.Y. TIMES (May 12, 2022), <https://www.nytimes.com/2022/05/12/opinion/vanguard-power-blackrock-state-street.html>.

meetings of most S&P 500 companies.²⁰⁴ 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.²⁰⁵ 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.”²⁰⁶ However, recently, the three firms have faced growing opposition for their ESG initiatives and growing influence.²⁰⁷ Such pushback is part of a broader backlash to ESG initiatives in the midst of an uncertain economic outlook.²⁰⁸ The backlash is starting to affect these asset manager’s own initiatives and even bottom lines.²⁰⁹

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.

²⁰⁶ John Jenkins, *Diversity: BlackRock Sets Board Diversity Target for U.S. Companies*, CORP. COUNS. (Dec. 17, 2021), <https://www.thecorporatecounsel.net/blog/2021/12/diversity-blackrock-sets-board-diversity-target-for-u-s-companies.html>; see also BLACKROCK, BLACKROCK INVESTMENT STEWARDSHIP: PROXY VOTING GUIDELINES FOR U.S. SECURITIES 8–9 (2023), <https://www.blackrock.com/corporate/literature/fact-sheet/blk-responsible-investment-guidelines-us.pdf>.

²⁰⁷ See Lydia Beyoud, *BlackRock, Vanguard Blasted by GOP Senators for ESG Proxy Voting*, BLOOMBERG (Dec. 6, 2022, 4:49 PM), <https://www.bloomberg.com/news/articles/2022-12-06/blackrock-vanguard-blasted-by-gop-senators-for-esg-proxy-voting> (explaining that BlackRock, State Street, and Vanguard “have been cast as among the biggest perpetrators”); Manjoo, *supra* note 203 (“BlackRock, Vanguard and State Street [] control too much of the global economy.”).

²⁰⁸ See, e.g., Opinion, Hans Taparia, *One of the Hottest Trends in the World of Investing Is a Sham*, N.Y. TIMES (Sept. 29, 2022), <https://www.nytimes.com/2022/09/29/opinion/esg-investing-responsibility.html> (arguing that ESG investing, particularly led by the Big Three, is misleading branding that instead simply focuses on maximizing shareholder profits); Opinion, Jed Rubinfeld & William P. Barr, *ESG Can’t Square With Fiduciary Duty*, WALL ST. J. (Sept. 6, 2022, 6:31 PM), <https://www.wsj.com/articles/esg-cant-square-with-fiduciary-duty-blackrock-vanguard-state-stree-the-big-three-violations-china-conflict-of-interest-investors-11662496552> (supporting state attorneys general for pushing back against ESG-focused investment firms because ESG-focused investing violates fiduciary duties); Opinion, Vivek Ramaswamy, *ESG and the ‘Long-Run Interests’ Dodge*, WALL ST. J. (Sept. 29, 2022, 2:01 PM), <https://www.wsj.com/articles/esg-and-the-long-run-interests-dodge-stockholders-apple-disney-chevron-equity-pressure-lgbtqa-company-climate-change-11664459307> (disputing Blackrock CEO Larry Fink’s argument that ESG practices advance long-run value creation for underlying companies).

²⁰⁹ See David Gelles, *How Environmentally Conscious Investing Became a Target of Conservatives*, N.Y. TIMES, <https://www.nytimes.com/2023/02/28/climate/esg-climate-backlash.html?action=click&module=Well&pgtype=Homepage§ion=US%20News> (Mar. 1, 2023) (discussing the growing backlash against E.S.G. and that “[t]here are some indications that the conservative pushback is gaining traction”); Ross Kerber, *Florida Pulls \$2 Billion From BlackRock in Largest Anti-ESG Divestment*, U.S. NEWS (Dec. 1, 2022), [https://www.usnews.com/news/top-news/articles/2022-12-01/florida-pulls-2-billion-from-blackrock-in-largest-anti-esg-divestment#:~:text=Dec.%201%2C%202022%2C%20at%209%3A14%20a.m.&text=\(Reuters\)%20%2D%20Florida's%20Chief%20Financial,corporate%20governance%20\(ESG\)%20policies](https://www.usnews.com/news/top-news/articles/2022-12-01/florida-pulls-2-billion-from-blackrock-in-largest-anti-esg-divestment#:~:text=Dec.%201%2C%202022%2C%20at%209%3A14%20a.m.&text=(Reuters)%20%2D%20Florida's%20Chief%20Financial,corporate%20governance%20(ESG)%20policies).

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.²¹⁰ 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,²¹¹ 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.²¹² 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.²¹³

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.²¹⁴ 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.²¹⁵ Regulators typically do not assess the explanations of non-adopting companies under comply-or-explain regimes, leaving the enforcement to the market.²¹⁶ However, in practice, non-adopting companies often give vague and less-than-quality explanations.²¹⁷ For example,

²¹⁰ Ross Kerber & Noor Zainab Hussain, *Vanguard Quits Net Zero Climate Effort, Citing Need for Independence*, REUTERS (Dec. 7, 2022, 4:21 PM), <https://www.reuters.com/business/sustainable-business/vanguard-quits-net-zero-climate-alliance-2022-12-07/>.

²¹¹ Lydia Beyoud, *BlackRock, Vanguard Blasted by GOP Senators for ESG Proxy Voting*, BLOOMBERG L. (Dec. 6, 2022, 4:49 PM), <https://www.bloomberg.com/news/articles/2022-12-06/blackrock-vanguard-blasted-by-gop-senators-for-esg-proxy-voting>.

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.

²¹⁵ Harper Ho, *supra* note 170, at 329–30.

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.

²²⁰ Sridhar Arcot, Valentina Bruno & Antoine Faure-Grimaud, *Corporate Governance in the UK: Is the Comply or Explain Approach Working?*, 30 INT'L REV. L. & ECON. 193, 199 (2010).

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.

²²⁶ Self-Regulatory Organizations, Securities Exchange Act Release, No. 34-90574, 85 Fed. Reg. 80472, 80488 (Dec. 4, 2020) (policy indicates no oversight).

Nasdaq's listing rule is appropriate."²²⁷ What is more, one study found that explanation instead of adoption was most common when a comply-or-explain code created controversial standards.²²⁸ Nasdaq's Diversity Inclusion Rule is undoubtedly a controversial code, as evidenced by responses in the media and the courts.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.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.²³¹ Widespread adoption of a comply-or-explain code's targeted practice begins with early adopters recognizing the economic value of adopting the code.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.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."²³⁴

Since Nasdaq's Diversity Inclusion Rule is a controversial code built on ethical rather than instrumental considerations,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

²²⁷ Letter from Zecca, *supra* note 149, at 8.

²²⁸ Seidl et al., *supra* note 218, at 813–14.

²²⁹ See Opening Brief for Petitioner, All. for Fair Bd. Recruitment v. Sec. & Exch. Comm'n, No. 21-60626 (5th Cir. Dec. 20, 2021) (arguing that the Rule constitutes a violation of the Vesting Clause, the First Amendment, and the Administrative Procedure Act); see also Amici Brief Supporting Petitioners, All. for Fair Bd. Recruitment v. Sec. & Exch. Comm'n, No. 21-60626 (5th Cir. Dec. 27, 2021) (joining in support of the petitioner in effort to have Nasdaq's Diversity Inclusion Rule overruled along with seventeen other states); Ed. Bd., *The Woke Nasdaq*, WALL ST. J. (Dec. 1, 2020, 6:39 PM), <https://www.wsj.com/articles/the-woke-nasdaq-11606865986>.

²³⁰ Self-Regulatory Organizations, Exchange Act Release No. 34-90574, 85 Fed. Reg. at 80497.

²³¹ Mensi-Klarbach et al., *supra* note 171, at 588.

²³² *Id.* at 579.

²³³ *Id.* (internal quotations omitted).

²³⁴ See *id.* (internal quotations omitted).

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.²³⁶ 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.²³⁷ 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 stakeholders 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

²³⁸ Self-Regulatory Organizations, Exchange Act Release No. 34-90574, 85 Fed. Reg. 80472, 80472 (Dec. 4, 2020); *see supra* Section II.B.

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.²⁴⁴ 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.²⁴⁵ 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."²⁴⁶ However, such deference to company discretion will compound the weaknesses that researchers have identified in comply-or-explain codes.²⁴⁷

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.²⁴⁸ 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.²⁴⁹ 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

²⁴⁴ Self-Regulatory Organizations, Exchange Act Release No. 34-90574, 85 Fed. Reg. 80472, 80488 (Dec. 4, 2020).

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.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.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.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.”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.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)) . . .”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

²⁵⁰ Seidl et al., *supra* note 218, at 799–800.

²⁵¹ See Abma & Olaerts, *supra* note 195, at 288–89.

²⁵² See, e.g., Leona Achtenhagen, Petra Inwinkl, Jacob Björktorp & Robert Källenius, *More Than Two Decades After the Cadbury Report: How Far Has Sweden, as Role Model for Corporate-Governance Practices, Come?*, 15 INT'L J. DISCLOSURE & GOVERNANCE 235, 243 (2018).

²⁵³ SWEDISH CORP. GOVERNANCE BD., THE SWEDISH CORPORATE GOVERNANCE CODE 26 (Jan. 1, 2020), https://www.corporategovernanceboard.se/UserFiles/Koden/The_Swedish_Corporate_Governance_Code_1_January_2020.pdf.

²⁵⁴ Sergakis, *supra* note 180, at 408.

²⁵⁵ See Self-Regulatory Organizations, Exchange Act Release No. 92590, 86 Fed. Reg. 44424 (Aug. 6, 2021).

goal of any comply-or-explain regime.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.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. *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.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.²⁵⁹ Because companies may not recognize controversial codes for economic value, resulting in more explanations than adopters,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.²⁶¹ Researchers that have identified this trend argue that additional forces are needed to implement a comply-or-explain code's targeted

²⁵⁶ Self-Regulatory Organizations, Exchange Act Release No. 34-90574, 85 Fed. Reg. 80472, 80497 (Dec. 4, 2020).

²⁵⁷ See Section IV.B.

²⁵⁸ See Abma & Olaerts, *supra* note 195, at 288; Arcot et al., *supra* note 209, at 199.

²⁵⁹ See Mensi-Klarbach et al., *supra* note 170, at 579.

²⁶⁰ See Arcot et al., *supra* note 209, at 199; Mensi-Klarbach et al., *supra* note 170, at 579.

²⁶¹ Mensi-Klarbach et al., *supra* note 170, at 579 (internal quotations omitted).

practice.²⁶² 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.²⁶³ 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.²⁶⁴ 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.²⁶⁵ However, this Comment suggests that the Listing Qualifications Department not just assesses non-adopting company explanations under the three-part requirement given in the previous subsection but also rate 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.²⁶⁶ 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.²⁶⁷ While the material standard largely leaves out any stakeholder interest beyond investors, it provides a minimum requirement with which companies are already familiar.²⁶⁸ 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.

²⁶⁴ Self-Regulatory Organizations, Exchange Act Release No. 34-90574, 85 Fed. Reg. 80472, 80488 (Dec. 4, 2020).

²⁶⁵ *Id.* at 80490.

²⁶⁶ *See* Harper Ho, *supra* note 169, at 341.

²⁶⁷ *TSC Indus., Inc. v. Northway, Inc.*, 426 U.S. 438, 449 (1976) (quoted in and applied by *Basic, Inc. v. Levinson*, 485 U.S. 224, 231–32 (1988)).

²⁶⁸ *See id.*

terms, legitimizing the economic benefits of diversity in companies.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.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.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.²⁷² Thus, market

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).

²⁷⁰ See Mensi-Klarbach et al., *supra* note 170, at 578.

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).

²⁷² Touched on in Part III of this Comment, 42% of Americans do not invest in American stock markets. Lydia Saad & Jeffrey M. Jones, *What Percentage of Americans Owns Stock?*, GALLUP, <https://news.gallup.com/poll/266807/percentage-americans-owns-stock.aspx> (May 12, 2022).

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.²⁷³ Nasdaq currently publishes certain listed-company information on its website, including dividend history and SEC filings.²⁷⁴ Therefore, such a recommendation is not outlandish considering the number of companies listed on the exchange and current Nasdaq publications.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."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.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

²⁷³ See *supra* notes 64–67 and accompanying text.

²⁷⁴ *Dividend History*, NASDAQ, <https://www.nasdaq.com/market-activity/quotes/dividend-history> (last visited Jan. 28, 2023).

²⁷⁵ See *id.*

²⁷⁶ See Abma & Olaerts, *supra* note 194, at 298–99.

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.

²⁷⁹ Opening Brief for Petitioner, All. for Fair Bd. Recruitment v. Sec. Exch. Comm'n, No. 21-60626 (5th Cir. Dec. 20, 2021).

²⁸⁰ Amici Brief Supporting Petitioners, All. for Fair Bd. Recruitment v. Sec. Exch. Comm'n, No. 21-60626 (5th Cir. Dec. 27, 2021).

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 Hears 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.²⁸³ 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.²⁸⁴ 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."²⁸⁵

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."²⁸⁶ 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.²⁸⁷ As argued in the Alliance for Fair Board Recruitment's

²⁸³ Self-Regulatory Organizations, Exchange Act Release No. 34-92590, 86 Fed. Reg. 44424, 44424 (Aug. 6, 2021).

²⁸⁴ *Id.*

²⁸⁵ 15 U.S.C. § 78f(b)(5), (8); *see* Self-Regulatory Organizations, Exchange Act Release No. 34-92590, 86 Fed. Reg. at 44424.

²⁸⁶ Self-Regulatory Organizations, Exchange Act Release No. 34-92590, 86 Fed. Reg. at 44425.

²⁸⁷ *See* Jerrod M. Lukacs, *Much Ado About Nothing: How the Securities SRO State Actor Circuit Split Has Been Misinterpreted and What It Means for Due Process at FINRA*, 47 GA. L. REV. 923, 927 (2013).

Opening Brief, such a finding would call for heightened scrutiny under the Fifth Amendment and even potentially the First Amendment.²⁸⁸ Currently, there is a circuit split with varying opinions on whether SROs like Nasdaq are considered state actors.²⁸⁹ 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.²⁹⁰

Important to whether Nasdaq would be ruled a state actor in all circuit tests is the interplay between Nasdaq and the government.²⁹¹ More specifically, these tests concern the level of involvement of the state—in this case, the SEC.²⁹² 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

²⁸⁸ Opening Brief for Petitioner at 21, 23, *All. for Fair Bd. Recruitment v. Sec. Exch. Comm'n*, No. 21-60626 (5th Cir. Dec. 20, 2021).

²⁸⁹ See Michael Deshmukh, *Is FINRA a State Actor? A Question that Exposes the Flaws of the State Action Doctrine and Suggests a Way to Redeem It*, 67 *VAND. L. REV.* 1173, 1178–80 (2014).

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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* Executive Managing Online Editor, *Emory Law Journal*, Volume 72; Emory University School of Law, J.D., 2023; Tulane University, B.S., 2019. I would first like to thank my faculty advisor, Commissioner Kristin Johnson, for her guidance throughout the writing process and congratulate her on her confirmation to the Commodity Futures Trading Commission. I would also like to thank my friends on the *Emory Law Journal* editorial staff, Hannah Baskind and Everett Stanley, for their hard work and time improving this piece. Finally, I am thankful to my family for their love and constant support throughout my time in law school. To my parents, Camille and Andy Salisbury Sr., and my sister and brother-in-law, Sara and Partha Reddy, thank you for shaping the person I am today.