# COMMENTS

**submitted on behalf of**

# Project on Fair Representation

**Concerning the**

***The Nasdaq Stock Market LLC;***

***Notice of Filing of Proposed Rule Change to Adopt Listing Rules Related to Board Diversity***

**File No. SR-NASDAQ-2020-081**


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## INTRODUCTION

Founded in 2005, the Project on Fair Representation is a not-for-profit legal defense foundation that is designed to support litigation that challenges racial and ethnic classifications and preferences in state and federal courts. The Project on Fair Representation appreciates consideration of its regulatory comments.

The Nasdaq Stock Market LLC ("Nasdaq") seeks the Securities and Exchange Commission's (SEC's) approval of a proposed exchange rule that would require certain Nasdaq-listed companies to have (A) "at least one director who self-identifies as female," and (B) "at least one director who self-identifies as Black or African American, Hispanic or Latinx, Asian Native American or Alaska Native, two or more races or ethnicities, or as LGBTQ+."[1] In the alternative, Nasdaq would require regulated companies—in writing—to "explain why" they do not comply with the two minority director set-asides required by the proposed exchange rule.

Nasdaq's discriminatory set-aside rules fail to advance the legitimate purposes of stock exchanges under the Exchange Act. While Nasdaq argues that its rule would improve corporate performance, its analysis is based on defective studies that are contradicted by more rigorous meta-analyses. Nasdaq has not presented "substantial evidence" that its discriminatory set-asides will enhance corporate governance. Nor does the rule govern securities markets. Nasdaq's rule is a forbidden attempt to engage in social legislation and invade internal corporate affairs, exceeding the authority of stock exchanges under the statute.

Even if Nasdaq's proposed rule were legally permissible under the Exchange Act and supported by substantial evidence (and it is not), it is not permissible under the U.S. Constitution. The U.S. Constitution's Fifth Amendment generally prohibits government discrimination based on gender, race, or sexual orientation. To approve this kind of discrimination in securities exchanges, the SEC would have to conclude that Nasdaq's rule survives the exacting scrutiny needed to justify the discriminatory treatment of individuals based on their gender, race, or sexual orientation. Nasdaq's pretextual interest in improving the securities market does not remotely justify discriminatory director set-aside rules based on gender, race, or sexual orientation. The proposed rule would also unconstitutionally compel speech, exceed federal authority, and raise serious separation of powers concerns.

The SEC has no choice—it must disapprove the unlawful proposed rule change.

In any event, the 24-day period for public comment—over major holidays—is too short to allow interested stakeholders a meaningful opportunity for comment on the statistical evidence presented by Nasdaq, as required by the Exchange Act and the Administrative Procedure Act. The SEC may not approve the proposed rule unless the period for public comment is extended to allow for meaningful comment on the statistical evidence that Nasdaq relies on to support this controversial proposal.

[1] 85 Fed. Reg. 80,472 (Dec. 11, 2020).

## I. NASDAQ'S PROPOSED RULE REGULATES MATTERS UNRELATED TO THE PURPOSES OF THE EXCHANGE ACT.

Under the Exchange Act, the SEC may approve the proposed rule change only "if it finds that such proposed rule change is consistent with the requirements of [the Exchange Act] and the rules and regulations issued under the [Act] that are applicable to such organization."[2] The SEC's findings must be "supported by substantial evidence,"[3] and the agency must engage in the "reasoned analysis" required by the Administrative Procedure Act.[4]

To be consistent with the Exchange Act, exchange rules must be

> "designed to prevent fraudulent and manipulative acts and practices, to promote just and equitable principles of trade, to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities, 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 are not designed to permit unfair discrimination between customers, issuers, brokers, or dealers, or to regulate by virtue of any authority conferred by this chapter matters not related to the purposes of this chapter or the administration of the exchange."[5]

Nasdaq may not "impose any burden on competition not necessary or appropriate" to advance these purposes.[6]

Nasdaq's proposed disclosure requirements and minority director set-asides are a blatant attempt to regulate "matters not related to the purposes" of the Exchange Act. Nasdaq seeks to leapfrog an ongoing social and political debate about diversity under the pretext of promoting the purposes of the Exchange Act. But Nasdaq relies on a one-sided analysis of inconclusive statistical evidence. There is no escaping it. Nasdaq's discriminatory set-aside rules are not supported by substantial evidence, are unrelated to the purposes of the Act, unlawfully govern internal corporate affairs outside the scope of the Act, and impose unnecessary burdens on member companies.

The SEC must disapprove the rule.

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[2] *Cf. Susquehanna Int'l Grp., LLP v. SEC*, 866 F.3d 442, 445 (D.C. Cir. 2017).

[3] 15 U.S.C. § 78y(a)(4).

[4] *Susquehanna Int'l Grp.*, 866 F.3d at 445 ("We review the Order under the Administrative Procedure Act").

[5] 15 U.S.C. § 78f(b)(5).

[6] *Id.* § 78f(b)(8).

### A. Nasdaq Has Failed to Show that the Proposed Set-Aside Rules Will Improve Corporate Performance.

#### 1. Nasdaq has not shown substantial evidence that the proposed female set-aside rule will improve corporate performance.

Nasdaq asserts that "[w]hile there are studies drawing different conclusions, Nasdaq believes that there is a compelling body of credible research on the association between economic performance and board diversity."[7] It asserts that "the overwhelming majority of studies" show a correlation between gender diversity and improved corporate financial performance.[8]

Nasdaq appears to believe that the accumulation of studies asserting a correlation is itself powerful evidence of a correlation. That is not how data science works. A mountain of bad science is still bad science. Nasdaq fails to account for the comparative statistical rigor of the different studies it cites, as well as the studies' relevance to the population of Nasdaq-listed U.S. companies. Some of the studies it cites are low-quality, self-serving attempts by investment advisors to promote high-fee ESG investing. Others do not study the relevant population of publicly listed U.S. companies. And yet others are contradicted by more rigorous analyses that find no or at best weak effects when controlling for the relevant explanatory variables. As Nasdaq admits, "the results of some other studies on gender diversity are mixed."[9] Indeed, rigorous peer-reviewed meta-analyses of the available data find no evidence of a robust correlation between gender diversity in the boardroom and corporate performance.[10]

Wharton Professor Katherine Klein, an avowed proponent of gender diversity in the boardroom, candidly summarizes the statistical evidence on gender diversity and corporate performance as follows:

> Rigorous, peer-reviewed studies suggest that companies do not perform better when they have women on the board. Nor do they perform worse. Depending on which meta-analysis you read, board gender diversity either has a very weak relationship with board performance or no relationship at all.[11]

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[7] 85 Fed. Reg. 80,476/3.

[8] *Id.* at 80,477/2.

[9] *Id.* at 80,476/3.

[10] *See, e.g.*, Jan Luca Pletzer et al., *Does Gender Matter? Female Representation on Corporate Boards and Firm Financial Performance – A Meta-Analysis*, PLoS ONE (June 18, 2015); Corinne Post & Kris Byron, *Women on Boards and Firm Financial Performance: A Meta-Analysis*, 58 Academy of Mgmt. J. 1546 (2015); U.S. GAO, Corporate Boards: Strategies to Address Representation of Women Include Federal Disclosure Requirements 5 (Dec. 2015).

[11] Social Impact, Does Gender Diversity on Boards Really Boost Company Performance (May 18, 2017), https://knowledge.wharton.upenn.edu/article/will-gender-diversity-boards-really-boost-company-performance/.

The weak correlation observed in some of the studies cited by Nasdaq may not even be pertinent to Nasdaq companies, as the population of companies studied could be different in meaningful respects. One cannot, for example, readily apply the experience of Norwegian corporations to U.S. companies, as these companies operate in very different legal and political environments and may differ in other meaningful respects.[12] Nasdaq's female set-aside rule lacks any rigorous, quantitative analysis of its member companies that adequately controls for explanatory variables and supports the asserted correlation for the population of interest.

Nasdaq even admits it does not have enough consistent and reliable data to determine the actual "diversity"—as Nasdaq defines it—of its own member companies' boards. The lack of reliable and consistent data is the very reason for Nasdaq's desire to impose a uniform boardroom "diversity" disclosure mandate. This disclosure requirement is in tension with the diversity set-aside rules. Nasdaq cannot both confidently assert that the data demonstrates a relevant correlation between board diversity and corporate performance, and then simultaneously plead that the paucity of available data is a reason to mandate diversity disclosures. If Nasdaq believes current corporate diversity disclosures are "unreliable, unusable, and insufficient to inform investment and voting decisions," it is not clear why it also believes the academic data is sufficiently rigorous to infer a causal relationship between diversity and corporate performance.[13] If sophisticated investors and even Nasdaq lack enough consistent data to measure board diversity, why would academics possess that kind of data? Nasdaq provides no answer.

In any event, several "mixed" studies finding at best weak correlations are not "substantial evidence" that women directors *cause* better financial performance.[14] Even robust correlations are not proof of causation.[15] It may be that companies with better corporate performance or investor protections tend to have more women on their board, and not vice versa. To suggest causation, Nasdaq would need to posit a causal mechanism that could explain why women cause better corporate performance. The best Nasdaq can do is assert that women bring "fresh perspectives" and help avoid "groupthink."[16] But these assertions are stereotypes, not a testable theory of causation.[17] They are not "substantial evidence" of causation.

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[12] 85 Fed. Reg. 80,496/1.

[13] *Id.* 80,483/2.

[14] *See Bus. Roundtable v. SEC*, 647 F.3d 1144, 1151 (D.C. Cir. 2011) ("In view of the admittedly (and at best) 'mixed' empirical evidence, we think the Commission has not sufficiently supported its conclusion that increasing the potential for election of directors nominated by shareholders will result in improved board and company performance and shareholder value.").

[15] One celebrated study once found a correlation between national chocolate consumption and national Nobel prize winners. Nasdaq would have the SEC assume that eating chocolate causes Nobel prize winners.

[16] 85 Fed. Reg. 80,472/2, 80,479.

[17] Karl R. Popper, Conjectures and Refutations: The Growth of Scientific Knowledge 37 (5th ed. 1989) ("'[T]he criterion of the scientific status of a theory is its falsifiability, or refutability, or testability'").

Nasdaq's assertions are particularly implausible in the context of publicly traded U.S. companies with efficient capital markets. If adding a woman to a board really could of itself cause significant increases in annualized corporate earnings growth, as some of the cited studies implausibly suggest, investors would have very powerful incentives to change the composition of corporate boards to boost share value and increase their wealth. If investors are not demanding the kind of boardroom diversity desired by Nasdaq, there are two possible explanations.

First, Nasdaq's "market failure" explanation. It could be that corporations listed on the Nasdaq exchange are grossly inefficient at protecting shareholders from bad directors because of some market failure. Nasdaq asserts that this "market failure" may be caused by the limits of "existing directors' social networks,"[18] but this arm-chair sociology does nothing to explain why investors—who elect directors—would tolerate recruitment practices that lead to decreased share value.

Second, and more plausibly, investors do not demand the kind of "diversity" favored by Nasdaq. Nasdaq apparently "believes" that companies make "progress" when the racial and gender diversity of their boards resembles the racial and gender diversity of the U.S population at large.[19] But it is unclear why demographic balancing based on race or gender in the boardroom would bring the kind of "progress" that investors generally care about—increased share value. Indeed, some statistical evidence suggests that the stock market tends to punish corporate diversity initiatives, as boardroom diversity initiatives may send a negative signal that a firm's leadership is more focused on pleasing outside stakeholders than enhancing shareholder value.[20]

To the extent corporate incentives to focus on boardroom diversity do exist, they appear more likely to be driven by firm marketing considerations, agenda-driven institutional investors managing other people's money (government-operated pension funds or large institutional investors seeking to burnish their own image), or government mandates. Advancing these often-political agendas is not the proper role of securities exchanges under the Exchange Act.

As a fallback, Nasdaq asserts that even if its female director set-aside will do nothing to improve corporate performance, it at least does no great harm, particularly because corporations can always "explain why" they choose not to comply by writing a public apology to Nasdaq.[21] But as Nasdaq knows and expects, companies will strive to avoid the negative backlash that would be generated by any such public explanation, and that will, in turn, lead firms to spend valuable resources to hire at least one female director, even when the

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[18] 86 Fed. Reg. 80,496/1.

[19] *Id.* at 80,480.

[20] Isabelle Solal & Kaisa Snellman, *Women Don't Mean Business? Gender Penalty in Board Composition*, 30 Org. Sci. (Oct. 1, 2019); Isabelle Solal & Kaisa Snellman, *Why Investors React Negatively to Companies that Put Women on Their Boards*, Harvard Business Review (Nov. 25, 2019).

[21] 86 Fed. Reg. 80,504/2.

incremental cost may provide no marginal benefit to corporate governance.[22] This pressure, predictably, will generate a "diversity" recruitment services rent which Nasdaq seeks to capitalize on in partnership with Equilar.[23] This will hurt investors, burden competition between exempt and non-exempt companies, and otherwise fail to advance any legitimate purposes of the Exchange Act.

The Court of Appeals for the D.C. Circuit has not hesitated to reverse the SEC when it has relied on "mixed" empirical evidence to formulate corporate governance rules for the country.[24] The evidence presented by Nasdaq here is far weaker, and the asserted market failure is far less plausible. An SEC order approving Nasdaq's rule will not survive judicial scrutiny.

The SEC must deny approval of the gender-diversity requirement.

#### 2. Nasdaq has not shown substantial evidence that the proposed race or sexual-orientation set-aside rule will improve corporate performance.

Nasdaq's case for a racial or sexual orientation director set-asides is even weaker. Nasdaq concedes "there is a lack of published research on the issue of LGBTQ+ representation on boards."[25] But instead of conceding it lacks substantial evidence, Nasdaq points to the Supreme Court's recent opinion in *Bostock v. Clayton County* to argue that the literature on *gender* diversity in the boardroom also justifies an LGBTQ+ set-aside requirement.[26]

Nasdaq's reliance on *Bostock* is misplaced. *Bostock* is about the meaning of the phrase "because of sex" in Title VII. It has no relevance to the question of whether statistical evidence

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[22] Nasdaq acknowledges that comply-or-explain requirements are meant to be a "regulatory impetus to drive meaningful and systemic change in board diversity," and cites evidence showing that this model has driven "progress" in other countries by forcing companies to consider diversity. 85 Fed. Reg. 80,496/2. Indeed, if the comply-or-explain had no coercive effect on diversity practices beyond encouraging disclosure, then it would also serve no useful purpose over and above the separate disclosure requirement and would also be illegal.

[23] Nasdaq Partners with Equilar, https://www.nasdaq.com/board-diversity/equilar. Although these search costs appear to vary, Nasdaq estimates $75,000 to $150,000 per director, or about a third of a director's annual salary, in search costs. 85 Fed. Reg. 80,504/3. Director pay ranges broadly as well, from about $100,000 or less to over $300,000 per year. *Id.*

[24] *See Bus. Roundtable*, 647 F.3d at 1151 ("In view of the admittedly (and at best) 'mixed' empirical evidence, we think the Commission has not sufficiently supported its conclusion that increasing the potential for election of directors nominated by shareholders will result in improved board and company performance and shareholder value.").

[25] 85 Fed. Reg. at 80,476/2, 80,494.

[26] *Id.* at 80,494/1 ("Nonetheless, Nasdaq believes it is reasonable and in the public interest to include a reporting category for LGBTQ+ in recognition of the U.S. Supreme Court's recent affirmation that sexual orientation and gender identity are 'inextricably' intertwined with sex, and based on studies demonstrating a positive association between board diversity and decision making, company performance and investor protections.").

on the effects of gender diversity can be properly extended to the LGBTQ+ context. There are meaningful differences between the two categories, which *Bostock* does not deny. "Self-identified" gender tends to correlate with biological distinctions between male and female, while LGBTQ+ status does not (a gay man is unlikely to self-identify as "female"). Nasdaq's reliance on *Bostock* thus only confirms that Nasdaq lacks any evidence—let alone "substantial evidence"—to support an LGBTQ+ set-aside rule.

Nasdaq's justification for an LGBTQ+ set-aside is also arbitrary and capricious because it fails to treat other similarly situated categories alike. Nasdaq justifies its failure to require veteran or disabled directors based on "a dearth of empirical analysis on the relationship between investor protection or company performance and broader diversity characteristics such as veteran status or individuals with disabilities."[27] In the same breath, it acknowledges a similar dearth of evidence exists for LGBTQ+ directors, and yet it does not hesitate to impose a set-aside.[28] Nasdaq provides no persuasive justification for this disparity in treatment.

Since Nasdaq's "minority" director requirement can be met with any person who self-identifies as LGBTQ+, regardless of race or ethnicity, Nasdaq cannot plausibly argue that its minority set-aside requirement is supported by "substantial evidence." In any event, Nasdaq also does not show substantial evidence that a racial set-aside will serve the purposes of the Exchange Act or enhance corporate performance. The existing literature focuses overwhelmingly on the possible effects of gender diversity in the boardroom, and the evidence on racial or ethnic diversity is even more mixed, unreliable, and ambiguous. It is not "substantial."

### B. Nasdaq's Proposed Rule is in Excess of Statutory Authority.

Apart from lacking substantial evidence, Nasdaq's rule is in excess of statutory authority.

To begin, the Nasdaq proposed rule concerns a major question and therefore does not receive *Chevron* deference. Courts "expect Congress to speak clearly if it wishes to assign to an agency decisions of vast economic and political significance."[29] This means that the SEC only has the authority to impose diversity set-asides through Nasdaq rulemakings if there is a "clear statement" of rulemaking authority to address that issue.[30] And Congress—particularly the 1934 Congress—never would have silently given the SEC or self-regulatory organizations

[27] 85 Fed. Reg. at 80,493/3.

[28] *Id.* at 80,494/1.

[29] *Util. Air Regulatory Grp. v. EPA*, 573 U.S. 302, 324 (2014) (citation omitted).

[30] *P.J.E.S. v. Wolf*, No. 20-cv-2245-EGS, 2020 WL 6770508, at *30 (D.D.C. Nov. 18, 2020); *see Whitman v. Am. Trucking Ass'ns*, 531 U.S. 457, 468 (2001) ("[Congress] does not . . . hide elephants in mouseholes."); *see also CFPB v. Accrediting Council for Indep. Colleges & Sch.*, 854 F.3d 683, 689 (D.C. Cir. 2017) ("Agencies are also not afforded unfettered authority to cast about for potential wrongdoing." (cleaned up)).

the authority to impose diversity set-asides on every publicly traded U.S. company in the country.

Furthermore, because Nasdaq is a private organization, not an executive agency charged with administering the Exchange Act, no deference is owed either to its findings of fact or its interpretations of the law. To the extent any deference is owed under the statute, it would be to the SEC's separate assessment of the evidence and views of the law. Thus, if the proposed rule becomes effective without any SEC findings of fact or conclusions of law, courts would have to review all questions of law and evidence de novo, including by considering any supplemental evidence necessary to correct Nasdaq's defective and one-sided record.

**1. Nasdaq's proposed rule is not designed to prevent fraudulent and manipulative acts or practices.**

Nasdaq argues that the proposed rule is consistent with the Exchange Act because it "believes that including diverse directors with a broader range of skills, perspectives and experiences may help detect and prevent fraudulent and manipulative acts or practices by mitigating 'groupthink.' "[31] But Nasdaq's rule is not designed to foster boards with a broader range of skills, perspectives, and experiences. It simply requires a token female and minority director, regardless of any actual difference in their actual skill, perspective, or experience relative to other directors.

Undeterred, Nasdaq also asserts that women are more ethical in several relevant dimensions relevant to corporate responsibility, including in their propensity to "question management" accounting practices and "pressure the external auditor."[32] To make this bold generalization, Nasdaq relies on anecdotal interviews of "Norwegian directors," and similar lines of unreliable or inconclusive evidence from proponents of diversity.[33] Nasdaq, meanwhile, provides no real evidence that boards with a director of a particular minority race or sexual orientation are any better at preventing fraudulent or manipulative acts or practices. None appears to exist.

Nasdaq's asserted "corporate responsibility" benefits from boardroom diversity are pretextual, speculative, and in any event insufficient to justify regulation. A rule that compels boardroom diversity is not a rule "designed to prevent fraudulent and manipulative acts and practices."[34] To fall under this authority, the rule would have to be designed to prevent some specific acts of fraud or manipulation. Boardroom diversity practices that may have ancillary correlations with improved corporate responsibility are not designed to prevent any specific

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[31] 85 Fed. Reg. 80,497/1.

[32] *Id.*

[33] *Id.* (citing Aaron A. Dhir, Challenging Boardroom Homogeneity (2016)).

[34] *Cf. United States v. O'Hagan*, 521 U.S. 642 (1997) (holding that an agency rule that "proscribes trading on undisclosed information in the tender offer setting, even in the absence of a duty to disclose" was "reasonably designed to prevent" fraud because "it is a fair assumption that trading on the basis of material, nonpublic information will often involve a breach of a duty of confidentiality to the bidder or target company or their representatives").

acts of fraud or manipulation. They are designed to promote boardroom diversity. Any correlation with corporate honesty is entirely ancillary to Nasdaq's overriding goal of promoting board diversity.[35]

**2. Nasdaq's proposed rule is not designed to promote just and equitable principles of trade.**

Next, an exchange rule is permissible if it is "designed . . . to promote just and equitable principles of trade." Nasdaq does not argue that its rule will "promote just and equitable principles of trade."[36] Nasdaq has no authority to impose the proposed rule under this authority, which requires exchanges to promote just and equitable principles "*of trade*"—in other words, to require that exchanges run trading floors that only countenance trades that are just and equitable. As one court put it, "[t]he purpose of the voluntary association is to provide self-regulation of the over-the-counter securities market."[37] The statute does not authorize rules to promote any internal corporate governance practices that Nasdaq's leadership deems socially just.

In any event, Nasdaq has failed to raise and therefore waived any arguments under this authority.

**3. Nasdaq's proposed rule is not designed to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities.**

Next, an exchange rule is permissible if it is "designed . . . to foster cooperation and coordination with persons engaged in regulating, clearing, settling, processing information with respect to, and facilitating transactions in securities."[38] Nasdaq does not argue that its rule will pursue this end. It clearly does not. This is a grant of authority for exchanges to regulate "transactions in securities," not every aspect of the internal governance of publicly traded companies.[39]

In any event, Nasdaq has failed to raise and therefore waived any arguments under this authority.

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[35] If Nasdaq's concern were ensuring proper corporate accounting, it would require more directors with a strong accounting or auditing background.

[36] 85 Fed. Reg. 80,499/1.

[37] *First Jersey Sec., Inc. v. Bergen*, 605 F.2d 690, 692 (3d Cir. 1979) (emphasis added).

[38] 15 U.S.C. §78f(b)(5).

[39] *Id.* (emphasis added).

### 4. Nasdaq's proposed rule is not designed to remove impediments to and perfect the mechanism of a free and open market and national market system.

Next, an exchange rule is permissible if it is "designed . . . to remove impediments to and perfect the mechanism of a free and open market and a national market system."[40] Nasdaq argues that the rule perfects the market for securities because it will encourage companies to hire director candidates "that otherwise may be overlooked due to the impediments of the traditional director recruitment process, which will thereby remove impediments to a free and open market and a national market system."[41] This is unpersuasive for several reasons.

First, it is unclear why Nasdaq believes the proposed rule will encourage companies to use non-traditional recruitment processes to hire female or minority directors. The rule does not prescribe any means of recruiting women or minority directors to the board. Nasdaq simply presumes that women and minorities will be hired through different channels or social networks, and that these directors will also have less "C-suite experience" than other directors. But Nasdaq has little or no evidence to support that broad generalization about recruitment practices in Nasdaq-listed U.S. companies.

Second, the rule does nothing to perfect the national market for securities trading. At most, it would perfect corporate director recruiting practices, but that is not the purpose of the Exchange Act, which governs securities transactions. As one Circuit explained, "to remove impediments to and perfect the mechanism of" simply means "to operate a fair and orderly exchange."[42] Operating a fair and orderly market may include, for example, indemnifying losses for trading errors or canceling erroneous transactions.[43] It includes promoting "economically efficient execution of securities transactions; [and] fair competition."[44] It includes regulating acts of bribery.[45] And it includes "remedying inefficient clearance and settlement procedures that impos[e] unnecessary costs on investors and those acting on their behalf."[46] It does not, however, include dictating how corporations ought to run their internal affairs. In other words, Congress wanted exchanges to provide publicly traded companies with a set of rules that ensure a free, fair, and orderly flow of securities transactions. It did not give exchanges carte blanche to regulate the internal matters of publicly traded companies,

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[40] 15 U.S.C. §78f(b)(5).

[41] 85 Fed. Reg. at 80,496/3.

[42] *NASDAQ OMX Grp., Inc. v. UBS Sec., LLC*, 770 F.3d 1010, 1021 (2d Cir. 2014) (emphasis added).

[43] *See id* at 1020–23.

[44] *Guice v. Charles Schwab & Co.*, 89 N.Y.2d 31, 40-41 (1996) (emphasis added).

[45] *See N.Y. Republican State Comm. v. SEC*, 927 F.3d 499, 506 (D.C. Cir. 2019); *Blount v. SEC*, 61 F.3d 938, 942, 945 (D.C. Cir. 1995).

[46] *Capece v. The Depository Tr. & Clearing Corp.*, No. 05-80498 CIV RYSKAMP, 2005 WL 4050118, at *6 (S.D. Fla. Oct. 11, 2005) (cleaned up) (emphasis added).

including director recruitment practices. But that is the only "market" Nasdaq's proposed rule would seek to "perfect."[47]

Nasdaq has overstepped its authority.

#### 5. Nasdaq's proposed rule is not designed to protect investors or the public interest.

An exchange rule is generally permissible if it is "designed . . . in general, to protect investors and the public interest."[48] Nasdaq asserts that its proposed rule is in the public interest because female directors are "positively associated with more transparent public disclosures."[49] This overbroad generalization, based on inconclusive evidence, cannot justify the proposed regulation for several reasons.

First, the rationale has nothing to do with the minority director set-aside requirement.

Second, Congress worded the Exchange Act to allow the SEC and private exchanges to regulate securities transactions rather than any internal corporate affairs that have alleged incidental effects on securities transactions.[50] Indeed, one court has indicated that this provision, which is a "general standard," "should be construed to embrace only issues similar to the specific ones" listed above, meaning only issues dealing with securities transactions.[51] The proposed rule regulates the gender, race, or sexual orientation of directors, not securities transactions.

Third, the term " 'public interest' is never an unbounded term," and must therefore be interpreted with a "confining principle."[52] The Court of Appeals for the D.C. Circuit adopted its own "confining principle"—that this provision does *not* mean that "an exchange may . . . exercise any governmental authority to 'regulate' the issuer." The Nasdaq rule crosses this line and purports to regulate internal corporate affairs, an issue reserved for state legislatures.

Fourth, courts have held in other contexts that a policy that is unreasonable or insufficiently justified does not "protect investors and the public interest"—indicating that this language is not a plenary grant of unreviewable authority to make rules for exchange participants.[53] This language must have limits, but the proposed Nasdaq rule—if justified under this provision—would give it no limits.

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[47] *See Weissman v. Nat'l Ass'n of Sec. Dealers, Inc.*, 500 F.3d 1293, 1299 (11th Cir. 2007); *Alaiyan v. Insightful Corp.*, 128 Wash. App. 1002 (2005).

[48] 15 U.S.C. §78f(b)(5).

[49] 85 Fed. Reg. at 80,498/3.

[50] *See Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Ware*, 414 U.S. 117, 129-31 (1973).

[51] *Bus. Roundtable v. SEC*, 905 F.2d 406, 413 (D.C. Cir. 1990).

[52] *Id.* at 413–14.

[53] *See Susquehanna Int'l Grp.,* 866 F.3d at 449–50.

### C. Section 342 of the Dodd-Frank Act Is Irrelevant.

Nasdaq tries to argue that diversity quotas advance the purposes of Section 342 of the Dodd-Frank Act. But that statute only ensures that agencies pursue diversity within the agency, and that they have non-binding standards for assessing the diversity of the firms they regulate.[54] The statute also says that "[n]othing in [the relevant paragraph] may be construed to mandate any requirement or . . . to require any specific action on the findings of the assessment."[55] Accordingly, Section 342 of the Dodd-Frank Act plainly does not support Nasdaq's attempt to mandate diversity in the boardroom.

## II. Nasdaq's Proposed Rule Violates the U.S. Constitution.

Even if the proposed set-aside rules were consistent with the Exchange Act and supported by substantial evidence, and they are not, they would be unconstitutional for multiple, independent reasons.

### A. Nasdaq's Proposed Rule Is Subject to Constitutional Scrutiny.

Nasdaq's rule is subject to constitutional scrutiny. It does not matter that Nasdaq is a "private" securities exchange. The rules of the Nasdaq exchange are only enforceable through an approval order by the SEC, Nasdaq has a federal duty to enforce its rules subject to SEC review, and Nasdaq is subject to the ongoing threat of SEC registration, suspension, or revocation if it fails to enforce its exchange rules.[56] Given the nature of the SEC's involvement in approving, superintending, and enforcing Nasdaq's exchange rules, an SEC order approving Nasdaq's proposed rule would be governmental action subject to the same constitutional scrutiny as any other reviewable agency action. [57] And under the Administrative Procedure Act, courts must "hold unlawful and set aside" any agency order that is "contrary to constitutional right, power, privilege, or immunity."[58] That is why the

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[54] 12 U.S.C. § 5452(b)(2)(C); *Final Interagency Policy Statement Establishing Joint Standards for Assessing the Diversity Policies and Practices of Entities Regulated by the Agencies*, 80 Fed. Reg. 33,016 (June 10, 2015).

[55] 12 U.S.C. § 5452(b)(4).

[56] 15 U.S.C. § 78s(e), (f), (g), (h). *See In re The Nasdaq Stock Market, LLC and Nasdaq Execution Services, LLC*, Admin. Proceeding File No. 3-15339 (May 29, 2013) (imposing sanctions on Nasdaq in part for failing to follow its rules in connection with Facebook's initial public offering).

[57] *See Shelley v. Kraemer*, 334 U.S. 1, 19 (1948) (judicial enforcement of private racial covenants was state action); *Moose Lodge No. 107 v. Irvis*, 407 U.S. 163, 172 (1972) ("[T]he impetus for the forbidden discrimination need not originate with the State if it is state action that enforces privately originated discrimination").

[58] 5 U.S.C. § 706(2)(B). If the SEC fails to act within the prescribed time period to approve or disapprove a proposed rule change, the order shall be deemed approved by the SEC by default. 15 U.S.C. § 78s(b)(2)(D). Such an approval by default would still be reviewable agency action under the Administrative Procedure Act, not agency inaction. It would also be government action reviewable under the Fifth Amendment. An approval by default would still be reviewable because (as noted) federal law imposes on Nasdaq an ongoing duty to enforce its exchange rules, subject to SEC supervision and sanction. *Id.* § 78s(g), (h).

Court of Appeals for the D.C. Circuit has held that similar self-regulatory organization rules approved by the SEC are government action subject to constitutional scrutiny.[59]

## B. Nasdaq's Proposed Set-Aside Rules Violate the Fifth Amendment.

### 1. The Proposed Female Set-Aside Rule Does Not Satisfy Heightened Scrutiny.

The proposed rule would violate equal protection principles protected by the Fifth Amendment. As the Supreme Court has held, "[e]qual protection analysis in the Fifth Amendment area is the same as that under the Fourteenth Amendment."[60] Under the Fifth Amendment, gender discrimination is subject to "heightened scrutiny," which means it "requires an exceedingly persuasive justification."[61] Courts view with "suspicion laws that rely on "overbroad generalizations about the different talents, capacities, or preferences of males and females."[62] The general classification must serve "important governmental objectives" through means "substantially related to" achieving those objectives.[63] Even if gender generalizations have "statistical support" and are "descriptive," the Supreme Court "reject[s] measures that classify unnecessarily and overbroadly by gender when more accurate and impartial lines can be drawn."[64] All gender discrimination is subject to the same stringent standard of review even if it is not motivated by "invidious" discrimination.[65]

Nasdaq's justification cannot survive the Supreme Court's "exceedingly persuasive justification" standard for gender discrimination under the Fifth Amendment.

First, Nasdaq's asserted interest in improving securities markets is not one of the "important governmental objectives" that has ever justified government-sponsored gender discrimination.

Second, Nasdaq's justification for a female director set-aside relies on at best mixed and weak statistical evidence and impermissible stereotypes about "cognitive diversity." Nasdaq thus fails to show that its gender-based classification substantially serves its asserted governmental objective.

Third, there are many more tailored, gender-neutral ways of promoting the "cognitive diversity" that Nasdaq allegedly seeks. Rules requiring directors with differences in

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[59] *Blount v. SEC*, 61 F.3d 938, 941 (D.C. Cir. 1995) (holding that a Municipal Rulemaking Securities Board rule approved by SEC was government action subject to constitutional scrutiny).

[60] *Adarand Constructors, Inc. v. Pena*, 515 U.S. 200, 224 (1995) (quoting *Buckley v. Valeo*, 424 U.S. 1, 93 (1976)).

[61] *Sessions v. Morales-Santana*, 137 S. Ct. 1678, 1690 (2017) (quoting *United States v. Virginia*, 518 U.S. 515, 555–56 (1996)).

[62] *Id.* (quoting *Virginia*, 518 U.S. at 533).

[63] *Virginia*, 518 U.S. at 533 (quoting *Miss. Univ. for Women v. Hogan*, 458 U.S. 718, 724 (1982)).

[64] *Morales-Santana*, 137 S. Ct. at 1693 & n.13.

[65] *Free the Nipple-v. City of Fort Collins, Colorado*, 916 F.3d 792, 800 (10th Cir. 2019).

educational attainment and background (e.g., financial auditing expertise), age, political affiliation, socioeconomic status, or any other number of gender-neutral criteria would seem to be a better suited and impartial means of achieving genuine "cognitive diversity" in the boardroom—at least the kind of cognitive diversity that may improve corporate boardrooms. Nasdaq provides no persuasive justification for its failure to consider viable and seemingly more accurate alternatives to achieving cognitive diversity.

Nasdaq's rule fails heightened scrutiny.

#### 2. Nasdaq's Proposed Race or Sexual Orientation Set-Aside Rule Does Not Satisfy Strict Scrutiny, Heightened Scrutiny, or Rational Basis Review.

"'Distinctions between citizens solely because of their ancestry are by their very nature odious to a free people.'"[66] There are no "benign" racial classifications; sorting people by race always "'stimulate[s] our society's latent race consciousness,'" "'delay[s] the time when race will become . . . truly irrelevant,'" and "perpetuat[es] the very racial divisions the polity seeks to transcend."[67] For that reason, the Supreme Court has held that racial classifications "must be analyzed by a reviewing court under strict scrutiny. In other words, such classifications are constitutional only if they are narrowly tailored measures that further compelling governmental interests."[68]

There are few, if any, compelling governmental interests that justify racially discriminatory set-asides. Remedying past invidious discrimination by a company may qualify as a compelling interest justifying discrimination, but the law remains unsettled.[69] In the unique context of higher education admissions practices, the Supreme Court has held that universities have a compelling interest in pursuing the educational benefits that may flow from racial diversity and may do so if race is narrowly used as no more than a flexible plus factor in the admissions process.[70] But even in this context, the Supreme Court has held that racial quotas, automatic "race" points, or any kind of inflexible admissions rules based on race are not permissible.

Improving the efficiency of securities markets is emphatically not a compelling interest that could ever justify racial discrimination. Nor is Nasdaq's rule narrowly tailored. Nasdaq seeks to characterize its "comply-or-explain" mandate as a flexible disclosure-based information-enhancing requirement, but Nasdaq fully expects that the mandate will have the

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[66] *Rice v. Cayetano*, 528 U.S. 495, 517 (2000).

[67] *Shaw v. Reno*, 509 U.S. 630, 643 (1993).

[68] *Adarand Constructors*, 515 U.S. at 227.

[69] *Id.* at 239 (Scalia, J., concurring in part and concurring in the judgment) ("In my view, government can never have a 'compelling interest' in discriminating on the basis of race in order to 'make up' for past racial discrimination in the opposite direction.").

[70] *Fisher v. University of Texas* (*Fisher II*), 136 S. Ct. 2198 (2016); *Grutter v. Bollinger*, 539 U.S. 306 (2003); *Regents of Univ. of Cal. v. Bakke*, 438 U.S. 265 (1978).

desired effect of forcing member companies to consider race as a criterion in hiring board members.[71] That is impermissible.

Because the rule contains a racial classification, it is subject to strict scrutiny, which it fails. But even if the rule contained only a sexual-orientation classification, it would also fail.

Although the Supreme Court has not specified the standard of review that applies to discrimination on the basis of sexual orientation,[72] the rule fails both intermediate and rational basis scrutiny.

First, at least one circuit has held that heightened scrutiny applies to discrimination based on sexual orientation,[73] and the sexual orientation set-aside, like that based on gender, conspicuously lacks the "exceedingly persuasive justification" required by this demanding level of review. Indeed, as explained above, unlike for gender, Nasdaq readily concedes that it lacks any statistical support relating to the effect of LGBTQ+ directors on corporate performance.

Second, and in the alternative, a sexual orientation set-aside would also fail under rational basis review because there is no "rational relationship between the disparity of treatment and some legitimate governmental purpose."[74] No evidence in the record provides rational support for treating LGBTQ+ directors differently than any otherwise similarly situated directors. The proposed rule would also both stigmatize minority directors with paternalistic tokenism, and stigmatize non-minority directors with a badge of inferiority because of race or sexual orientation, "a stigma and injury of the kind prohibited by our basic charter."[75]

The SEC must deny approval of the minority set-aside rule.

### C. Nasdaq's Proposed Rule Violates the First Amendment.

The proposed rule also violates the First Amendment by impermissibly compelling directors and companies to speak, in the forms of (1) requiring companies to publicly to comply with a diversity mandate or explain why they do not, and (2) requiring disclosure of board diversity data.

The Nasdaq set-aside rules inappropriately compels corporations to either adopt unconstitutional and controversial classifications based on gender, race, or sexual orientation

[71] 84 Fed. Reg. 80,496/2.

[72] *See, e.g., Obergefell v. Hodges*, 576 U.S. 644 (2015) (holding that homosexual marriage was a fundamental liberty protected by the Fourteenth Amendment but not specifying the level of scrutiny for sexual orientation discrimination).

[73] *See SmithKline Beecham Corp. v. Abbott Labs.*, 740 F.3d 471, 481 (9th Cir. 2014).

[74] *Armour v. City of Indianapolis, Ind.*, 566 U.S. 673, 680 (2012).

[75] *Obergefell*, 576 U.S. at 671.

when hiring directors or explain why they do not—a form of compelled political apology.[76] This "comply-or-explain" requirement—as well as the requirement to disclose board diversity data—compels the disclosure of controversial information from companies without satisfying the strict scrutiny required by the First Amendment.

In *National Institute of Family & Life Advocates v. Becerra (NIFLA)*, the Supreme Court held that a compelled disclosure is subject to strict scrutiny unless it falls into one of two categories—"laws that require professionals to disclose factual, noncontroversial information in their 'commercial speech,'" and regulation of "professional conduct, even though that conduct incidentally involves speech."[77]

As in *NIFLA*, the Nasdaq comply-or-explain and disclosure data requirements do more than incidentally regulate speech. Under the proposed rule, a company that does not have at least two diverse directors must explain its reasons for not having these directors either "in the company's proxy statement or information statement for its annual meeting of shareholders or, alternatively on the company's website."[78] The rule also requires that companies annually disclose their board diversity statistics.[79] These requirements are not forced disclosures of "factual, *noncontroversial* information in . . . 'commercial speech.' "[80] The compelled disclosure of a company's reasons for failing to hire directors of certain prescribed races, genders, and sexual orientations is palpably different from examples of required disclosures of noncontroversial information cited by the proposed rule, such as a requirement to disclose whether a company has at least one audit committee financial expert.[81] The Nasdaq rule requires disclosure of highly controversial information, and it is not a regulation of companies' commercial speech, as the speech is entirely rule-created. The rule is therefore subject to strict scrutiny.

Furthermore, the proposed rule's compelled disclosure of an explanation for not having two diverse directors and its compelled disclosure of board diversity statistics cannot survive strict scrutiny because these requirements serve no compelling governmental interest. And even if a compelling governmental interest existed for the required explanation, requiring such a public apology to all of a company's shareholders, or to the general public if the company chooses the option of posting on its website, is not a narrowly tailored means to achieve any such interest.

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[76] *See* 85 Fed. Reg. 80,502/1.

[77] 138 S. Ct. at 2372 (2018).

[78] 85 Fed. Reg. 80,502/1.

[79] *Id.* at 80,486.

[80] 138 S. Ct. at 2372 (emphasis added).

[81] *See* 85 Fed. Reg. 80,502 (referencing Regulation S-K, Item 407).

### D. Default Approval of Nasdaq's Proposed Rule Would Violate the Private Non-Delegation Doctrine and the Appointments Clause.

If the SEC fails to act within 45 days, the proposed rule may be approved by default.[82] Such a means of approval may be convenient for Nasdaq, but approval by default would violate the private non-delegation doctrine and the Appointments Clause.

The Exchange Act provides that a proposed rule change shall be deemed to have been approved by the SEC if the SEC does not approve or disapprove the proposed rule change within 45 days after the date of publication.[83] This raises constitutional concerns under the private non-delegation doctrine. Under that doctrine, agency delegation to a private entity is only lawful on the condition that "the entities function subordinately to the federal agency and the federal agency has authority and surveillance over their activities."[84] When an agency delegates a statutory duty, the agency may not "reflexively rubber stamp[]" a rule prepared by a private entity but instead must "independently perform its reviewing, analytical and judgmental function and participate actively and significantly in the preparation and drafting process."[85]

The proposed rule setting diversity set-asides for corporate boards is a legislative rule that governs "private conduct."[86] If the SEC does not review and affirmatively approve or disapprove this proposed rule, the SEC will not have exercised the necessary "authority and surveillance" over Nasdaq's regulatory activities, as required by the non-delegation doctrine. Thus, an automatic approval by the SEC of the proposed rule after the 45-day window would amount to an unconstitutional "rubber stamp" of a legislative rule prepared by a private entity.[87]

For similar reasons, an SEC rubber stamp would also violate the Appointments Clause. Article II of the Constitution demands that the President generally appoint all "Officers of the United States" with the Senate's advice and consent.[88] This provision ensures that those who exercise the power of the United States are accountable to the President, who

[82] *See* 15 U.S.C. 78s(b)(2)(D)(i) (providing that a proposed rule change shall be deemed to have been approved by the SEC if the SEC does not approve or disapprove the proposed rule change within 45 days after the date of publication).

[83] *Id.*

[84] *Texas v. Rettig*, 968 F.3d 402, 414 (5th Cir. 2020) (internal quotation marks omitted); *see also Dep't of Transp. v. Ass'n of Am. Railroads*, 575 U.S. 43, 61 (2015) (Alito, J., concurring); *id.* at 87 (Thomas, J., concurring in the judgment).

[85] *See Sierra Club v. Lynn*, 502 F.2d 43, 59 (5th Cir. 1974).

[86] *See Ass'n of Am. Railroads*, 575 U.S. at 70 (Alito, J., concurring) ("[T]he formulation of generally applicable rules of private conduct . . . requires the exercise of legislative power.").

[87] Even if the SEC approved the rule, the statute may be an unlawful delegation of authority to the SEC, as Congress itself must regulate important subjects like boardroom diversity or at least supply an intelligible principle for regulation. *See Gundy v. United States*, 139 S. Ct. 2116, 2123 (2019).

[88] Art. II, § 2, cl. 2.

himself is accountable to the people.[89] The Supreme Court has held that someone who exercises "significant authority pursuant to the laws of the United States" is an officer.[90]

The power to promulgate legislative rules governing the internal affairs of public corporations pursuant to the Exchange Act would certainly qualify as "significant authority" under federal law. Such significant rules must be adopted or at least properly ratified by lawfully appointed executive officers, not by Nasdaq's politically unelected President and CEO, who has never been appointed to federal office. As Justice Alito has noted, "nothing final should appear in the Federal Register unless a Presidential appointee has at least signed off on it."[91]

### E. The SEC is Unconstitutionally Insulated from the President's Removal Power.

Any action to approve Nasdaq's proposed rule would also be unconstitutional because SEC commissioners are unlawfully insulated from presidential control.

SEC Commissioners have some degree of legal independence from presidential oversight because they may not be removed by the President except for good cause, meaning inefficiency, neglect of duty, or malfeasance in office.[92] That is the same standard of tenure protection that the Supreme Court recently held unconstitutional under the separation of powers in *Seila Law v. CFPB*.[93] The only difference here is that the SEC is a multimember commission.

That is irrelevant. The limited Supreme Court exception for "multimember expert agencies that do not wield substantial executive power" does not apply to the SEC, which has enormous executive power to implement statutes "in a major segment of the U.S. economy" and exercises regulatory and adjudicative powers that are almost a carbon copy of the CFPB's executive powers under Title X of the Dodd-Frank Act, which the Supreme Court deemed "substantial executive power" in *Seila Law*.[94] The SEC is therefore unconstitutionally insulated from presidential control.

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[89] See *Free Enterprise Fund v. PCAOB,* 561 U.S. 477, 497–498 (2010) (citing The Federalist No. 72, p. 487 (J. Cooke ed. 1961) (A. Hamilton)).

[90] *Lucia v. SEC*, 138 S. Ct. 2044, 2051 (2018) (quoting *Buckley v. Valeo*, 424 U.S. 1, 126, n. 162 (1976) (per curiam).

[91] *Ass'n of Am. Railroads*, 575 U.S. at 64 (Alito, J.).

[92] *PCAOB*, 561 U.S. at 496 (assuming that is the case).

[93] 140 S. Ct. 2183, 2197 (2020).

[94] *Id.* at 2199–200.

## III. THE NOTICE FAILS TO PROVIDE A MEANINGFUL OPPORTUNITY FOR PUBLIC COMMENT.

In the alternative, the SEC must at least provide additional time to comment on the proposal.

When a self-regulatory organization proposes a rule change, the Exchange Act requires that SEC publish a notice in the Federal Register and then "give interested persons an opportunity to submit written data, views, and arguments concerning such proposed rule change."[95] The Administrative Procedure Act similarly requires "an adequate period for eliciting meaningful comments."[96]

In this case, the notice of proposed rule change was published in the Federal Register on December 11, 2020. Comment is due on January 4, 2021.[97] That timeline gives the public 13 business days (or 24 calendar days) to review Nasdaq's filing, the dozens of statistical studies cited by Nasdaq, gather other relevant statistical evidence for the record, and then write comments.

That is woefully inadequate. The Court of Appeals for the D.C. Circuit has held that "[w]hen substantial rule changes are proposed, a 30-day comment period is generally the shortest time period sufficient for interested persons to meaningfully review a proposed rule and provide informed comment."[98] The proposed rule changes here are substantial and required the analysis of a mass of complex statistical evidence. Under D.C. Circuit precedent, giving the public only 13 business days to comment would thus be reversible procedural error.[99]

Regardless, good agency practice requires extending the comment period. The comment period falls significantly short of the minimum 60-day comment period recommended by the Administrative Conference of the United States for regulations that raise significant novel legal or policy issues, and even the recommended 30-day minimum comment period for rules that are not "significant."[100] Given the lead time provided by Nasdaq in the proposed rule, extending the comment period for an additional 30 days or more would not prejudice Nasdaq in any plausible way, and it would allow the public a meaningful, instead of illusory, opportunity to comment.

The SEC should extend the comment period for an additional 30 days, at a minimum.

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[95] 15 U.S.C. § 78s(b)(1).

[96] *Nat'l Lifeline Ass'n v. FCC*, 921 F.3d 1102, 1117 (D.C. Cir. 2019).

[97] 85 Fed. Reg. at 80,505/3.

[98] *Nat'l Lifeline Ass'n*, 921 F.3d at 1117.

[99] *Id.*

[100] Administrative Conference Recommendation 2011-2 (June 16, 2011).

## **CONCLUSION**

Nasdaq's proposal is unlawful, unconstitutional, and procedurally defective. The SEC must disapprove the rule.