How Nasdaq’s Board Diversity Rule Creates Potential for Real Change

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The new rules requiring qualitative and quantitative disclosure about board diversity will better inform investors and (hopefully) spur further progress.

On 6 August 2021, the United States Securities Exchange Commission (SEC) approved rules, collectively dubbed Nasdaq’s Board Diversity Rule, relating to the demographics of boards of directors of Nasdaq-listed companies. In the few months since, commentary has focused on the supposed need to grow the pool of qualified directors from diverse backgrounds, the belief that these directors will need special training in public company board norms and the logistics of allocating board seats to new directors.

We have noted two trends among business and legal writers in examining the impact of the Rule. First, analyses often include implicit assumptions that overlook important realities. Second, they largely omit discussions of how to leverage the changes the Rule will create to most effectively generate the benefits of board diversity.

To achieve the full potential of the Rule in promoting demographically diverse boards of public companies that have a positive impact, the business community must understand exactly what the new rules mean and for whom.

Nasdaq considers a director to be from a diverse background if the director is

- a woman
- an underrepresented minority or
- LGBTQ+

Comply more inclusively – or explain honestly

Despite its name, Nasdaq's Board Diversity Rule does not *de jure* compel Nasdaq-listed companies to have diverse boards. Rather than a mandatory board composition regulation, the set of Nasdaq rules should, instead, be viewed as a move towards more robust requirements for public disclosure about board-level diversity.

These requirements take two forms. First, beginning in August 2022, Nasdaq-listed companies will have to disclose annual statistics about their board's diversity using a "**matrix**" prescribed by Nasdaq. This simple format has versions for US and foreign companies, and both include board members' self-disclosed gender identity, relevant underrepresented racial/ethnic/religious identities, and LGBTQ+ status. Although Nasdaq will permit some variability in the **style** of presentation, the standardisation of substance should allow for greater comparability within individual companies and industries over time and across companies and industries.

Second, for board composition, Nasdaq sets phased-in targets, the focus of much commentary. The initial objective for all Nasdaq-listed companies is to have one director from a diverse background by August 2023. For the largest Nasdaq-listed companies, the final objective is two directors from diverse backgrounds (meaning, for US companies, one woman and one underrepresented minority or LGBTQ+ individual) by August 2025. Smaller companies have an extra year to meet the two-director target, and for those with small boards, the target remains one director from a diverse background.

These objectives are not, however, mandates – unlike those for gender parity in several jurisdictions including **Norway and a half dozen European Union countries**, **India**, **Malaysia** and **South Africa** and for gender and underrepresented minorities in the **state of California** (currently facing a legal challenge). Instead, Nasdaq relies on a “comply or explain” framework, meaning that companies can *either* meet the applicable board diversity objective *or* include disclosure of the reasons they do not. The Rule is explicit that providing this explanation will suffice to avoid delisting.

The **Nasdaq graphic** below details the phase-in periods for the listing tiers (and for smaller boards) and makes clear that companies always have the option to provide an explanation. While acknowledging that progress towards diversity may be slower than with mandates, Nasdaq indicated that it preferred this framework based on consultations, suggesting the US business community would find a disclosure-based approach **“less controversial”**.

	Initial Board Matrix	One Diverse Director or Provide Explanation*	Two Diverse Directors or Provide Explanation*
Nasdaq Global Select or Global Markets	August 8, 2022 or the date the company files its 2022 proxy, whichever is later	August 7, 2023 (2 years)	August 6, 2025 (4 years)
Nasdaq Capital Market			August 6, 2026 (5 years)
Boards with 5 or fewer directors			N/A

More inclusive compliance

Companies seeking to meet the board diversity objectives can truly leverage the power of board diversity if they are mindful of considerations beyond numerical targets. In proposing the Rule, Nasdaq reviewed dozens of academic and industry studies and concluded that compelling evidence exists to establish a correlation between diverse boards and better economic performance, investor protection and board decision-making.

The mere presence of directors from diverse backgrounds is not, however, a magic token that automatically triggers these positive outcomes. Research demonstrates, instead, that increased **demographic diversity** can lead teams to be better prepared, more rigorous and more innovative. In turn, improved board governance and decision-making are linked to changes in board behaviour such as greater oversight, willingness to hold officers accountable and less groupthink, thanks to improved examination and integration of available evidence. Rather than preparing new directors to conform to the traditional dynamics of public company board service, companies seeking to maximise the benefits of diversity should be concerned with preparing sitting directors to collaborate effectively in a diverse decision-making team.

Although our suggestions deviate from current board norms, they are well-grounded in robust research evidence on innovative **performance**. This body of research has shown how creating more opportunities for dissenting views to be shared and thoughtfully examining mistakes (viewing them as opportunities for collective learning and growth) improve team and organisational performance. For members of underrepresented groups, these practices and **the culture they create** also foster feelings of being included and being heard, and enable individuals to share their expertise.

Additionally, how new directors are brought in to the board room may affect both their own and others' views of their legitimacy. In interviews with African-American public company directors, **Henderson** found that even when they knew that diversity was a primary consideration in their selection, these directors felt accepted and respected when the announcement of their election or appointment emphasised the substantive knowledge and skills they brought to the board and when committee assignments matched their expertise or allowed for meaningful contributions.

Such onboarding circumstances can naturally enable **self-affirmation** that shifts attention away from potentially threatening identities marked by underrepresentation. Consistent with this thinking, after joining a board in Singapore, a woman director with a background in banking shared with Kinias her sense that her voice became meaningful after she was placed on the board's finance committee.

Similarly, to minimise resistance, when considering how to allocate seats for directors from diverse backgrounds, commentators and companies should be aware of terminology, perceptions and the potential impact of increasing board size. Use of the word "replace" may trigger implicit associations with the **"great replacement"** conspiracy theory currently resurging in far-right circles. Board "renewal" and director "rotation" are common terms and practices, and companies are invited to review or adopt policies in these areas to incorporate diversity considerations.

Expansion of the board to create new seats for directors from diverse backgrounds comes with a financial cost that may create the impression that diversity is dilutive rather than accretive. Board expansion may also subtly signal that these seats are set apart as a separate class, creating **fault lines** between sitting and incoming directors, again pointing to rotation and renewal being better approaches.

Pitfalls of insincere explanations

The opportunity to "explain" presents an alternative to meeting the board diversity objectives, and Nasdaq makes explicit that it will not evaluate the substance or merits of explanations. A company cannot, however, simply state that it does not meet the objectives but must put forward some "insight into the company's circumstances or diversity philosophy". In a comment letter during the SEC's review of the proposed rules, Nasdaq provided examples of **cursory explanations** that would pass Nasdaq muster.

The lack of Nasdaq scrutiny does not, however, preclude substantive review by investors or application of the anti-fraud provisions of US securities laws. If investors demand details about a company's non-compliance (which Nasdaq expressly anticipates), then investor review can become a catalyst for meaningful discussion of perceived challenges to board diversity. The potential for securities litigation may also motivate companies to avoid explanations that are merely pretexts for a lack of serious effort to diversify their boards. For example, Nasdaq provides a sample explanation based on concerns about feasibility. The accuracy or sincerity of this explanation could be challenged by pointing out a robust pipeline of board-ready **women** and **underrepresented minorities** as well as the availability of Nasdaq's **free board recruiting services**.

Companies unwilling to undertake serious efforts to meet the board diversity objectives may be better served by disclosing their disagreement with the Nasdaq approach or their use of director selection criteria other than diversity (both examples provided by Nasdaq). Such explanations would convey the relative value the company places on board diversity. "Comply or explain" does not force board diversity, but it does force companies to take a position on it publicly.

Will investor pressure follow?

Together, the "explain" framework and the standardised matrix will increase the information about board diversity available to investors. "Explain" will provide qualitative insights about an individual non-compliant company's philosophy, while the matrix disclosure will provide quantitative data about each Nasdaq-listed company, enabling investors to identify companies doing more than the minimum with respect to diversity goals. These disclosures create comparability, allowing investors who care about board diversity to invest in companies that show a similar commitment and to withdraw investments from those that don't.

One potential outgrowth of increased and standardised disclosure is greater awareness of the significant underrepresentation of directors from diverse backgrounds globally. Even though non-US companies can meet the two-director target by having two female directors rather than one woman and one underrepresented or LGBTQ+ individual, the matrix requires disclosure of numbers for each category (where not prohibited by law). When framed against the numeric representation of women and underrepresented minorities in the societies that organisations are ultimately tasked with serving, observed **gaps can motivate** further progress.

Nasdaq rationale for the Rule includes arguments that investors increasingly care about diversity, and market reactions in the coming years will reveal to what depth. Investor response to the disclosed content and to the way firms frame the information will speak to this assertion.

Conclusions for companies and investors

The new Rule is a call to action for private companies before they undertake a listing. Venture capital and private equity investors, as well as founders with future listing ambitions, should plan wisely for the disclosure both to begin to enjoy the benefits of board diversity prior to their IPOs and to minimise board disruption after listing.

The Rule opens the door for input from socially conscious institutional shareholders as well as from activist investors. Equipped with accessible data, investors can press for a diverse slate of board candidates prior to the annual general meeting and vote (or withhold votes) at the meeting based on their stated preference. Smaller shareholders can also engage, showing the importance they believe diversity merits through their votes or through board diversity-related shareholder proposals.

Large asset managers should also consider the disclosures resulting from the Rule in their risk management frameworks and portfolio mandates. Moving from a single-minded financial target (clearly represented by one number) to a multi-targeted approach is a complex process, as shown by the industry's struggle to include consistent and meaningful ESG guidelines.

Although integrating change to meet and effectively leverage the new Rule will require some effort and attention both from companies and their investors, we expect thoughtful strategies to pay back a different kind of dividend. The US population is 51 percent female and 40 percent underrepresented racial or ethnic identity. Combined, they make up over 70 percent of the total population. By expanding the pool of potential directors beyond the numeric minority and creating conditions for diverse boards to be effective, investors and Nasdaq companies as well as the societies they serve can all benefit from the Rule.

Find article at
https://knowledge.insead.edu/leadership-organisations/how-nasdaqs-board-diversity-rule-creates-potential-real-change

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