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# U.S. Public Pension Fund Diversity Initiatives: Practices, Rationales, and Constitutionality

Angela Cai

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# U.S. Public Pension Fund Diversity Initiatives: Practices, Rationales, and Constitutionality

*Angela Cai**

*This Article examines the efforts of U.S. pension funds to promote racial and gender diversity. Some pensions not only promote corporate board diversity through direct and indirect lobbying and proxy voting efforts, but also favor asset managers that are owned or operated by women and minorities.*

*This paper is the first to explore these latter programs. I first examine the practice in the context of pensions' diversity-promotion agenda as a whole. Next, I explore three likely rationales for why pensions have taken up diversity promotion as a goal, proposing three potential rationales: business, equality, and politics.*

*Without taking a position on whether the ultimate social implications of these diversity efforts are positive or negative, I argue that the practice of favoring women and minority asset managers is unlikely to withstand constitutional review. After charting the nuances of how lower courts have applied government contracting affirmative action programs after* Croson *and* Adarand, *I apply these insights to minority and women asset manager hiring programs. My analysis, which focuses on unique aspects of the asset management business, concludes that public pension funds face a steep uphill battle should these diverse manager-recruiting programs be challenged in court. While it is not impossible for a fund to summon adequate evidence of past discrimination and tailor a program to meet the narrow tailoring requirements, the current programs appear to fall short.*

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## I. INTRODUCTION

Increasing gender and racial diversity in the business world has long been a concern of U.S. academic, regulatory, and business communities. While companies are puzzling over whether and how to pursue diversity as a norm of corporate governance, another set of financial institutions has taken a different track and taken large strides to promoting diversity: defined-benefit public pension funds in the United States. Despite coming under heavy fire for a number of problems, including severe underfundedness, these funds espouse a surprisingly strong commitment to diversity. For example, some have lobbied corporations and the Securities and Exchange Commission ("SEC") for greater minority and female representation on corporate boards. Some have created allocations for "emerging managers" that include – and are sometimes defined exclusively as – investment funds run by women and ethnic and racial minorities ("diverse managers"). These funds pursue these goals despite the lack of empirical verification that diversity in company or fund management causes better performance, and despite healthy opposition from entities who challenge diversity-seeking efforts as impermissible racial classification.

The efforts that U.S. public pension funds ("PPFs") take to promote diversity are understudied. This paper explores these funds' commitment to diversity as a unique phenomenon in a landscape where attitudes, rules, and norms about diversity in corporate governance and financial investments are on shaky ground. In Part II, I describe the ways in which PPFs have contributed to promoting diversity in the corporate governance and asset management spaces. In the corporate governance space, PPFs have supported the SEC's proxy disclosure rule that requires companies to disclose whether and how they consider diversity in board selection, and have undertaken direct lobbying efforts and supporting third-party initiatives. On the asset management front, a number of PPFs have – either by legislation or by investment committee action – performed specialized searches for investment management firms and brokerage firms owned and operated by women and minorities.

Next, I identify three potential rationales that drive public pension funds to engage with the project of promoting diversity: a business case, an equality-based case, and a political case. These rationales apply in different manners depending on what approach the PPFs' diversity initiatives take form: they operate differently for the corporate governance front and the investment management front. I focus on the investment management front, which has never before been synthesized and evaluated.

The business rationale case is rooted in a belief that pursuing these initiatives could pay off for the pension funds. This could occur through better performance, either by the corporation in which the pensions are shareholders or by the investment managers who manage some of the pension's assets. I examine both logical and empirical evidence for these claims, and find that though there is some evidence to suggest that a business case for diversity could exist, the findings are too mixed and the evidence too weak for a profit-maximizing institution to rely on. However, the fact that pensions – which do seek to maximize returns, especially in light of underfundedness – nevertheless pursue these initiatives suggests that they are interested in either a long-term payoff strategy or have other motives for pursuing diversity.

One alternative rationale is that the pensions are trying to combat the effects of inequality qua inequality. I analyze this approach from the perspectives of pensions, and explore both a remediation-based logic and an impact-based logic. The former is focused on correcting the effects of past discrimination. The latter focuses on the fact that those who manage pension assets look fundamentally different from the demographics of the beneficiaries.

Finally, I explore a third "rationale," which is that the funds are responding to political pressures to make visible strides towards diversity.

Understanding the reasoning for the funds' efforts can help frame a crucial question: whether these initiatives, in particular the manager selection programs, are likely to be considered by courts constitutional under the Equal Protection Clause. In the second half of this Article, I argue that the latter strategy of manager selection is an example of race- and gender-based classification in government contracting.

After considering these rationales, I argue that though no cases to date have been filed and no academic analysis is performed on these grounds, PPF diverse manager initiatives likely trigger constitutional problems. In Part IV, I analyze the complex landscape of jurisprudence on government contracting affirmative action across courts to-

day, and apply the prevailing standards to PPF programs. First, I argue that PPF programs are race-conscious state actions, which means they are subject to strict scrutiny review. Strict scrutiny requires a showing of compelling state interest and narrow tailoring. I next sketch out some of the roadblocks in establishing a strong evidentiary basis for remedial efforts to combat past discrimination, which is necessary to satisfy the first prong of the strict scrutiny test.

In Part V, I show that these diverse asset manager hiring programs are unlikely to meet the strict scrutiny test. First, it is very difficult to be able for government entities to marshal the kind of disparity study comparisons that government contracting programs currently use to justify diversity hiring as a compelling state interest. Next, I explore the ways in which narrow tailoring analysis could stymie the efforts of programs that theoretically have passed the compelling state interest test. Ultimately, I conclude that these programs are very unlikely to survive strict scrutiny under the applicable standards advanced by the Supreme Court in *City of Richmond v. Croson*,[1] *Adarand Constructors v. Pena*,[2] and their progeny in federal courts of appeal and state high courts.

## II. THE DIVERSITY-PROMOTION EFFORTS OF U.S. PUBLIC PENSION FUNDS

There is an increasing trend towards enacting diversity initiatives among PPFs. The efforts can be roughly categorized in two veins: the first is to support corporate board diversity and the second is to support diversity in the investment management business. While the first approach has been long-recognized, the second has not. Within the PPF manager-search space, there are a numerous requests for proposals ("RFPs") for minority managers that demonstrate these pensions are aware of and in pursuit of diversity goals in their manager selection processes. The following section first introduces the corporate diversity angle and subsequently focuses on the methods used by PPFs to support diversity in investment management.

### A. *Supporting Corporate Board Diversity*

Many PPFs have long supported increased diversity on corporate boards. Many publicly-traded companies have dire underrepresentation of women and ethnic minorities in corporate leadership, and many shareholders – PPFs among them – believe in voting in qualified

1. City of Richmond v. J.A. Croson Co., 488 U.S. 469, 508 (1989).
2. Adarand Constructors, Inc. v. Pena (*Adarand III*), 515 U.S. 200, 205 (1995).

underrepresented candidates. However, their efforts to promote diversity include more than just voting for women or minority candidates. First, some PPFs and similar entities lobby for and promote diversity through supportive public statements and through buttressing third-party initiatives. These initiatives include efforts to increase corporate board diversity and diversity in the investment management business.

### 1. Direct Lobbying

In 2010, the SEC issued a new proxy rule that requires public companies to disclose how, if at all, their corporate board of directors selection processes take into account the subject of diversity.[3] The SEC rule requires companies to

> [d]escribe . . . whether, and if so how, the nominating committee (or the board) considers diversity in identifying nominees for director. If the nominating committee (or the board) has a policy with regard to the consideration of diversity in identifying director nominees, describe how this policy is implemented, as well as how the nominating committee (or the board) assesses the effectiveness of its policy[.][4]

The upshot of this rule is that corporations filing statements with the SEC would have to include more information than before about corporate board diversity, though the margin of that additional information is slim. Companies are not asked to define diversity,[5] nor is there an explicit specificity requirement with respect to the processes disclosed. Nevertheless, the rule received some criticism from commentators who remarked that the SEC's rule is unnecessary.[6] Another form of criticism was stronger and more targeted, primarily focus on whether diversity disclosure is not germane to the SEC's regulatory role and corporations' duties in selecting qualified candidates

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3. SEC Proxy Disclosure Enhancements, 74 Fed. Reg. 68,334, 68,355 (Feb. 28, 2010) (codified at 17 C.F.R. pt. 240.14a-101 (2010)).

4. SEC Regulation S-K, 17 C.F.R. § 229.407 (2010).

5. Lisa Fairfax has criticized the SEC's failure to define diversity as potentially devastating to the rule's effect. *See* Lisa M. Fairfax, *Board Diversity Revisited: New Rationale, Same Old Story?*, 89 N.C.L. REV. 855, 874-75 (2011).

6. *See* Comment Letter from Alexander M. Cutler, Chairman and CEO of Eaton Corporation, Chair of Corporate Leadership Initiative, Business Roundtable, to Elizabeth M. Murphy, Sec'y, SEC 6 (Sept. 15, 2009), *available at* http://www.sec.gov/comments/s7-13-09/s71309-69.pdf (commenting that diversity disclosure is unnecessary); Comment Letter from Cleary Gottlieb Steen & Hamilton LLP to Elizabeth M. Murphy, Sec'y, SEC 7 (Sept. 15, 2009), *available at* http://www.sec.gov/comments/s7-13-09/s71309-118.pdf (stating that the diversity disclosure would be "unhelpful"); Comment Letter from Jeffrey W. Rubin, Chair of the Comm. on Fed. Reg. of Sec., ABA to SEC, 26 (Oct. 16, 2009), *available at* http://www.sec.gov/comments/s7-13-09/s71309-152.pdf (noting that many companies already consider diversity).

for board governance.[7] One comment letter from the Center for Equal Opportunity, a conservative think tank, took a strong position against the SEC's diversity disclosure rule, stating, "We strongly oppose any consideration of race or ethnicity in selecting individuals for a position on a corporate board. Such discrimination is wrong. It is also illegal."[8]

But among the slate of comment letters the SEC received, several were from PPFs and affiliates who were in support of the diversity disclosure provisions and, thus, supported the rule. Some letters specifically mentioned support for diversity initiatives. For example, California State Teachers Retirement System ("CalSTRS") Chief Investment Officer ("CIO") Christopher Ailman wrote in a letter to the SEC that CalSTRS

> wholeheartedly believes corporate board diversity is an important issue. Over the past several years, both our (United States) academic and business communities have focused greater attention on the influence of gender, racial and cultural diversity on boards of directors and organizational contexts generally. The changing demographics of the United States and the increasing international exposure of many U.S. companies makes it important that corporate boards have a wide-range of cultural backgrounds and a breadth of experiences . . . . At CalSTRS, we have demonstrated our commitment to this issue by submitting proposals to companies asking them to consider diversity as a criterion in their board recruitment process during the most recent proxy season.[9]

CalSTRS's strong support statement was backed by an exhibition of its own initiatives to promote change at the company level. Its peer fund California Public Employees Retirement System ("CalPERS") wrote in support as well, noting that it "supports amending [the rule]

7. Comment Letter from John C. Guerra, Jr., CEO, New America Alliance, to Elizabeth M. Murphy, Sec'y, SEC 1-2 (Sept. 2, 2009), *available at* http://www.sec.gov/comments/s7-13-09/s71309-31.pdf (arguing that asking for disclosure of diversity in qualifications for board directors is unwise because diversity is not a qualification).

8. Comment Letter from Roger Clegg, President and General Counsel, Center for Equal Opportunity, to SEC (Sept. 1, 2009), *available at* http://www.sec.gov/comments/s7-13-09/s71309-26.htm ("For a company to engage in racial or ethnic discrimination would violate 42 U.S.C. [§] 1981, which forbids such discrimination in any contractual relationship, which would include the relationship between a board member and a corporation. If board members are considered company employees, then it would also violate Title VII of the 1964 Civil Rights Act, 42 U.S.C. [§] 2000e et seq.").

9. Comment Letter from Christopher Ailman, CIO, CalSTRS, to Elizabeth M. Murphy, Secretary, SEC 2-3 (Sept. 14, 2009), *available at* http://www.sec.gov/comments/s7-13-09/s71309-84.pdf. *But see* Comment Letter from Meredith Williams, Executive Director, Colo. Public Employees Retirement Association, to Elizabeth M. Murphy, Sec'y, SEC, Sep. 15, 2009, *available at* http://www.sec.gov/comments/s7-13-09/s71309-75.pdf (focusing entirely on the value of transparency, but did not specifically mention diversity).

to require disclosure of the additional factors that a nominating committee should consider in recruitment, such as diversity."[10] The rule also received support from the Connecticut State Treasurer, who oversees the state pension fund,[11] the Council of Institutional Investors (an association of pension funds),[12] and Aon Consulting, a firm that works closely with many pension funds on investment strategies and operations.[13] Aon's CEO, Kathryn Hayley, wrote, "I believe board diversity to be critically important, and strongly encourage the SEC to adopt this amendment."[14]

In a more direct lobbying effort, PPFs also directly communicate dissatisfaction with board composition to the firms themselves. For example, in a letter in February 2012, CalSTRS expressed dissatisfaction with Facebook's board of director composition, before the company's IPO was completed. In part, the letter stated:

> We are disappointed that the Facebook board will not have any women members. This is particularly glaring in view of the fact that Facebook is going public at a time when there is clear evidence that companies with diverse boards perform far better than the companies with more homogeneous boards. We also note that the Facebook COO, Sheryl Sandberg has been very supportive of increasing the diversity on corporate boards, particularly gender diversity, and in the senior management of corporations.[15]

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10. Anne Simpson, Senior Portfolio Manager, Global Equity, CalPERS, to Elizabeth M. Murphy, Sec'y, SEC 3 (Sept. 16, 2009), *available at* http://www.sec.gov/comments/s7-13-09/s71309-146.pdf. Interestingly the letter came from Anne Simpson, who was a Senior Portfolio Manager at CalPERS. *Id.* at 5. While its Chief Investment Officer Joe Dear and Senior Investment Officer Eric Baggesen were copied, *id.*, it is not clear why CalPERS chose to have the letter come from someone who is not an executive at the fund.

11. Comment Letter from Denise L. Nappier, State Treasurer, Connecticut State Treasurer, to Elizabeth M. Murphy, Sec'y, SEC, 7 (Sept. 15, 2009), *available at* http://www.sec.gov/comments/s7-13-09/s71309-104.pdf.

12. Comment Letter from Justin Levis, Senior Research Associate, Council of Institutional Investors, to Elizabeth M. Murphy, Sec'y, SEC 3 (Sept. 8, 2009), *available at* http://www.sec.gov/comments/s7-13-09/s71309-33.pdf.

13. Comment Letter from Kathryn J. Hayley, CEO, Aon, to Elizabeth M. Murphy, Sec'y, SEC (Sep. 10, 2009), *available at* http://www.sec.gov/comments/s7-13-09/s71309-42.htm.

14. *Id.*

15. Letter from Anne Sheehan, Director of Corporate Governance, CalSTRS to Mark Zuckerberg, Chairman and CEO, Facebook Inc. (Feb. 7, 2012), *available at* http://www.calstrs.com/sites/main/files/file-attachments/letter_facebook.pdf. Facebook was not the only highly publicized IPO to face backlash for not having any women on its initial boards. Twitter suffered the same fate when it was revealed that its seven-person board contained no women, but eventually appointed one woman before its IPO. *See* Sarah Frier & Jeff Green, *Twitter Names Majorie Scardino as First Woman to Join Board*, BLOOMBERG.COM, Dec. 5, 2013, http://www.bloomberg.com/news/2013-12-05/twitter-names-marjorie-scardino-as-first-woman-to-join-board.html. *See also* Lauren Hepler & Shana Lynch, *Twitter's not alone - 8 other Silicon Valley IPO companies have no women on board*, SILICON VALLEY BUS. J. (Oct. 8, 2013), *available at* http://www.bizjournals.com/sanjose/news/2013/10/08/why-twitters-problem-is-silicon.html?page=all.

In the meantime, similar efforts are being adopted on the legislative and executive level. Besides the SEC's proxy disclosure rule, a number of other state governments have moved to increase diversity in corporate boards. For example, New York City comptroller Scott Stringer appointed a "chief diversity officer," whose goal is to increase diversity by "[w]orking with the Comptroller's corporate governance team on supplier, workplace and board diversity initiatives[.]"[16] The California state senate unanimously passed a resolution that encourages public-traded companies in California to appoint at least one woman member for boards with fewer than five seats, and more women for boards larger than that.[17]

2. Supporting Third Party Efforts

Statements, such as letters to the SEC, are not the only way that PPFs have made affirmative public efforts to support diversity in corporate governance. PPFs also have made efforts to promote external efforts to increase board diversity. For example, in 2008, California State Controller John Chiang called on CalPERS and CalSTRS to work on constructively broadening efforts to promote corporate board diversity. In a statement in 2009, he made the following call to action:

> With proxy access, we have an opportunity to do what is good – and do it in a way that makes shareowners responsible partners . . . . It is not effective or responsible for shareowners to wait for the Annual General Meeting and hope they can just vote down candidates offered up by management . . . . My question to you is what can we do to help search firms and nominating committees attract real, diverse talent?[18]

As a result, CalPERS and CalSTRS created a joint initiative with "other investors, companies, search firms, diversity networks, and aca-

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16. Comptroller Scott M. Stringer Appoints Carra Wallace Chief Diversity Officer, Press Release, Office of the New York City Comptroller (Mar. 7, 2014), *available at* http://comptroller.nyc.gov/newsroom/comptroller-scott-m-stringer-appoints-carra-wallace-chief-diversity-officer/#sthash.0v5Eii4Z.dpuf. *See also* Dorreen E. Lilienfield, *Measures to Increase Gender Diversity on Corporate Boards*, NEW YORK LAW JOURNAL, Jan. 7, 2014, http://www.newyorklawjournal.com/id=1202636453791/Measures+to+Increase+Gender+Diversity+on+Corporate+Boards%3Fmcode=0&curindex=0&curpage=ALL.

17. S. Con. Res. 62, 2013 Leg. Reg. Sess. (Cal. 2013), *available at* http://www.leginfo.ca.gov/pub/13-14/bill/sen/sb_0051-0100/scr_62_bill_20130711_introduced.pdf. For a graphical resolution, see *California Senate Concurrent Resolution 62 Urging More Women on Boards*, PUBLIC POLICY IMPACT, U. CAL. DAVIS (2013), *available at* http://gsm.ucdavis.edu/sites/main/files/file-attachments/public-policy-impact.pdf.

18. John Chiang, *Opening Remarks, September 2009 Workshop*, CALPERS, *available at* http://www.CalPERS-governance.org/marketinitiatives/initiatives/board-diversity/sept2009-workshop (last visited Jan. 6, 2015).

demics" to create the "Diverse Director Datasource (3)," which is a repository of board-ready diverse candidates.[19] As of October 2012, the initiative has "recruited more than 450 candidates . . . with several hundred more in the pipeline."[20]

### B. *Manager Selection Efforts*

The aforementioned methods of voting for diverse candidates, lobbying for corporate diversity initiatives, and supporting third-party efforts have been relatively well-publicized and well-studied. However, one of the most prominent ways in which PPFs support diversity efforts is through setting aside allocations for "diverse" managers. There has been little to no attention paid to this approach thus far outside of trade journals.

#### 1. Overview of Pension Fund Manager Selection Process

Pension fund assets – the pool of state money that pays beneficiaries' pensions – are managed by both internal and external investment managers. Often, a large portion of the assets are managed by external managers. These external investment managers, and the funds they operate, are usually categorized by the type of asset they manage for the pensions. For example, a pension fund that allocates 20% of its asset to be invested in international equities would typically hire a number of different international equities investment firms/funds, and each would manage a sub-portion of that 20% allocation. The investment management firms compete for these allocations by submitting detailed applications by completing "requests for proposal" ("RFPs"). When a pension fund adds an allocation to a particular asset (for example, by reallocation 2% of plan assets from international bonds to international equities), or if they want to switch out one manager for another within the same asset class allocation, they issue RFPs. Interested investment managers fill out those RFPs and subsequent selection processes – including more data submission, presentations, interviews, and negotiations – will yield the ultimate manager. Often, the application process is mediated by consulting firms or other search firms.[21]

19. ICGN Survey on Board Diversity, CALPERS 3 (Oct. 26, 2012), *available at* http://www.calpers-governance.org/docs-sof/marketinitiatives/resources/icgn-board-diversity-survey-calpers-final.pdf.

20. Id.

21. *See, e.g.*, *Investment Manager Database*, FIS GROUP, *available at* http://www.fisgroup.com/fis-managers/case-for-fis-managers (last visited Jan. 6, 2015).

PPFs may have general guidelines for types of investment managers, or allocation-specific guidelines. An allocation-specific example would be where a search for bond managers requires that the investment management fund only invest in bonds of a certain duration. A general guideline example would be that only funds over a certain size, or assets under management ("AUM"), would be hired. Some of these guidelines are specifically listed in the RFP, so that investment managers that do not fit the qualifications are barred from applying or being considered. Others are uncommunicated internal preferences, which means that the pension funds would simply reject certain managers' RFPs because of certain failures to meet these preferences. For example, a pension fund may prefer longer track records for managers, but not explicitly state this in RFPs. A fund that started two years ago, therefore, might send in an application RFP but would not win the investment mandate from a pension fund that has always preferred established investment managers.

2. Selecting for "Emerging Managers" and Diverse Managers"

Instead of selecting purpose on traditional measures such as performance, tenure, fund AUM, leverage ratio, and custom tailoring, some pensions prefer that some of their assets be managed by "emerging managers."[22] The term can refer to two types of asset managers. First, funds owned or primarily run by women or minorities, and second, funds with operational characteristics that are not conventionally desireable – smaller and newer funds.

The concept of emerging managers has been around for over twenty years. In 1990, Ed Callan (the founder of the eponymous pension consulting firm) and Marx Cazenave, the first black stockbroker at E.F. Hutton and a former California governor's office advisor, formed the Progress Fund, which is an fund-of-funds or incubator platform for women and minority managers.[23] The Progress Fund has pooled over $100 million in allocations from pensions, including the Maryland State Retirement System, to be managed by these diverse managers.[24]

That there are competing definitions of "emerging manager" is important because it reveals that the underlying impetus for such a cate-

22. *Emerging Manager Programs: A Best Practices Overview*, NAT'L ASS'N OF INV. COS. 1 (Jun. 2011), *available at* http://www.naicpe.com/publications/NAIC-EmergingManagerPrograms.pdf.

23. *See Progress Investment Interactive Timeline*, PROGRESS INV. MGMT. CO., *available at* http://www.progressinvestment.com/flash/timeline.php (last visited Jan. 6, 2015). California set up its emerging manager program in 1990.

24. *Id.*

gory of investment managers is not straightforward. Thurman White, the Chief Executive Officer ("CEO") of the Progress' Fund, now the Progress Investment Management Company, wrote in a 2008 reflection that in the 1990s, the term "emerging manager" arose "in the wake of concerns about legal challenges to affirmative action," and originally was "a euphemism for 'owned by women or minorities.'"[25] White added that today's definition of "emerging manager" is different, that it "has become synonymous with 'independently owned' and all the positives typically associated with employee-owned businesses — caring, originality, risk-taking, innovation and hard work by people with a real, long-term stake in their companies."[26]

The muddiness of definition persists. While the "industry definition" refers to funds that manage below $2 billion in AUM, that definition is far from uniformly-adopted. Some PPFs specifically use the emerging market allocation to target firms and funds owned by or managed by minorities, women, and other groups traditionally underrepresented in the U.S. financial management industry. For these PPFs, diversity, rather than operational characteristics like age and AUM, is the primary factor.[27] Others focus on the age and AUM of the fund, but see diversity as an "auxiliary benefit" of emerging manager programs.[28]

Throughout this paper, I will use "diverse manager" to refer to those programs that specifically target women and minorities, and "emerging manager" to refer to those with no explicit gender- or race-based categorizations, while understanding that at times the vocabulary in practice is blurred. The two categories are not mutually overlapping in what they offer to investors. The rationales for investing with smaller AUM managers can be very different from rationales for investing with managers operated by racial minorities or women. The positive characteristics attributed to smaller AUM funds - such as nimbleness in shifting positions, lower correlation in return streams that diversify the PPFs' overall portfolios, and responsiveness at the management level - are not necessarily replicated in larger funds that

25. Thurman V. White, Jr., *From Diversity to Diversification: The Evolution of the Term "Emerging Manager"*, PROGRESS INV. MGMT. CO. 1 (July 2008), *available at* http://www.progressinvestment.com/content/files/TheEvolutionoftheTermEmergingManager-Essay5.pdf.

26. *Id.*

27. *See* Randy Diamond, *Public pension funds' definition of emerging manager still a work in progress*, PENSIONS & INVS., Mar. 21, 2012, http://www.pionline.com/article/20120321/ONLINE/120329976/public-pension-funds-definition-of-emerging-manager-still-a-work-in-progress.

28. *Investment Office Diversity and Inclusion Resources*, CALPERS (Aug. 6, 2014), *available at* http://www.CalPERS.ca.gov/index.jsp?bc=/investments/targeted-programs/diversity-owned-business.xml ("[A]n ancillary benefit of our emerging manager strategies is greater ethnic and gender diversity among CalPERS external fund managers.").

are owned or managed by minorities and women. Similarly, advantages potentially ascribable to minority-owned funds, such as rectifying past discrimination and access to capital from underdeveloped resource areas like urban neighborhoods, are not necessarily applicable to funds that simply have low AUMs.[29]

There has been criticism of the blending of the different approaches. As the emerging manager trend has continued, some argue that the minorities-based approach is inappropriate for PPFs:

> To many, it appeared as if the pension funds' decision makers were capitulating to pressure from minority voters and/or vocal civil rights organizations. This initial reaction upset experienced minority and some non-minority professionals, who had observed that the number of qualified emerging managers had increased dramatically across the country. Indeed, many of these professionals had graduated from top business schools and honed their investment expertise by working in top-tier private equity firms.[30]

Despite the criticisms regarding political capitulation, the trend for allocating to emerging managers has continued. A number of PPFs have set aside semi-permanent allocations specifically to these emerging managers, and RFPs have proceeded accordingly to target these types of managers. These allocations include direct investments in emerging managers and investments through fund-of-fund platforms that specifically aggregate emerging managers.

A number of large PPFs have robust programs in place by legislative decree. Three of the nation's largest PPFs, CalSTRS, CalPERS, and the New York State Common Fund ("NYSCF") were pioneers in this field. Two other large PPFs have followed suit: the Illinois Public Employees Retirement Fund and the Maryland Treasury Department, which oversees its Public Employees Retirement Fund, both have Emerging Manager programs. Except for the California programs, these legislative programs include explicit and specific reference to ownership/management by minorities and women.[31]

In addition, many PPFs have adopted Emerging Manager allocations by way of investment guidelines, even without the prompting of legislative mandates. Progress Investment Management Company, a fund-of-funds of emerging managers platform, whose underlying managers include diverse managers, counts among its clientele a number

29. See *infra* Part III.A. for a discussion of the differences between the rationales for pursuing these two categories of investments.

30. *Emerging Manager Programs: A Best Practices Overview*, *supra* note 22, at 2.

31. *See infra* Part IV.A. for details about the race-categorical nature of these programs.

of state plans that do not have legislative mandates.[32] The investment guidelines of states like Connecticut[33] and Texas[34] provide good examples of non-legislated efforts for diverse and emerging managers, respectively. Indeed, one only has to briefly glance at the RFP aggregation postings in trade publications to see that there are numerous opportunities for emerging manager searches, and some are RFPs inviting only diverse managers.[35]

Finally, in addition to hiring diverse investment managers to invest plan capital, some PPFs also have policies of placing business with minority and women-owned brokerage firms. For example, the aforementioned Chicago Teachers' Pension Fund has a board-set policy of having at least 50 percent of their U.S. Equities portfolio in separately-managed accounts to be placed with broker/dealer firms owned by minorities, women, or individuals with disabilities.[36] The Connecticut pension's investment policy targets 25% of "securities trading bro-

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32. *See* Thurman White, Jr. & Mona Williams, *Manager of Emerging Managers Overview*, PROGRESS INV. MGMT. CO. 14 (Mar. 14, 2012), *available at* http://www.surs.com/pdfs/minutes/x_inv/03_2012/ex16.pdf (including Minnesota, Connecticut, and Virginia, and city plans like Milwaukee). Progress also has a number of corporate pension and endowment clients. *Id.*

33. Denise L. Napier, *Investment Policy Statement for the State of Connecticut Retirement Plans & Trust Funds*, STATE OF CONN. TREASURER'S OFFICE, *available at* http://www.ott.ct.gov/pensiondocs/IPStatement.pdf. The policy's Appendix C, Section II outlines diversity principles, and describes the "Connecticut Horizon Fund" as a program that "provide[s] opportunity for investment managers who, for multiple reasons, would not typically have full access" to the fund. *Id.* at 235. Specifically, it states:

> It is the expressed intent of the CRPTF to afford opportunities for emerging, minority and women-owned and Connecticut-based investment managers to compete for investment contracts so long as such managers are fully capable of providing investment management services consistent with investment strategy and fiduciary standards.

*Id.* The fund also set diverse brokerage firm targets. *Id.* at 234.

34. *Investment Policy*, EMPS RET. SYS. OF TEX. (Dec. 5, 2014), *available at* http://www.ers.state.tx.us/About_ERS/ERS_Investments/ERS_Investment_Policy/. The guidelines define emerging managers as

> [A] private professional investment manager with assets under management of not more than $2 billion. Private financial services include pension fund management, consulting, investment advising, brokerage services, hedge fund management, private equity fund management, and real estate investment . . . . ERS must report to its Board of Trustees the methods and results of its efforts to hire emerging fund managers, including data disaggregated by race, ethnicity, gender and fund size.

*Id.* at 66.

35. *See e.g.*, *Search Roundup*, 8 EMERGING MANAGER MONTHLY 15 (Oct. 2013); Appendix A-1.

36. *Chicago Teachers' Pension Fund Request for Proposals: Emerging Markets Equity Manager Search*, CHI. TEACHERS' PENSION FUND 4 (2012), *available at* http://www.ctpf.org/general_info/rfps/emergingmarkets2012.pdf [hereinafter *Chicago Teachers' Pension*]. The minimum threshold utilization rate of diverse broker-dealers for other asset classes are lower, but significant asset allocations such as international equities and fixed income still require 25 percent utilization of diverse broker-dealers under the Fund's current policy. *Id.*

kerage commissions to minority broker-dealers and/or women broker-dealers" and 5% to "emerging broker-dealers."[37]

### C. *Other Efforts to Support Diverse Financial Enterprises*

There are a number of other ways in which PPFs promote diversity in the asset management space outside of direct hiring.

First, even for RFPs that do not specifically target minority and women-owned asset managers, PPFs sometimes signal the importance of diversity by asking for disclosures about the funds' employee base. For example, a recent RFP seeking emerging markets equities managers for the Chicago Teachers' Pension Fund asks applicant funds to fill out a matrix specifying the race and gender proportions of their entire operations.[38] The matrix asks for disaggregated data on the number of employees along categories of function (investment professionals, sales, IT, etc.) and by race and gender; a completed table would be a snapshot of the race and gender breakdown of the entire investment management firm.[39]

Additionally, the Connecticut Retirement Plans and Trust Funds adopted a "Diversity Principles" statement in 2006 that mandates financial services firms to have "in place or agree to adopt written policies that promote diversity in the workforce" and demonstrate "ongoing efforts" to do so. It requires that these firms "disclose their firms' workforce diversity statistics in a form prescribed by the State Treasurer during the RFP or search process."[40] It also requires an updated "workplace diversity report" from both the firm and its suppliers.[41]

It is not clear how exactly PPFs that ask for this kind of information utilize it in their manager searches. For some, however, it is an explicit protocol to consider the make-up of the applicant manager. The Connecticut protocol states, "Workforce diversity shall be considered by the Treasurer when making her decision to recommend a firm to the IAC [investment advisory committee], and the Treasurer's recommendation shall include her analysis and conclusions regarding the diversity profile of each firm recommended."[42] Even for others that are not so explicit in their instruction, one thing that is clear is that this information has at least two functions. The first is that it allows PPFs

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37. Napier, *supra* note 33, at 234.
38. *See Chicago Teachers' Pension*, *supra* note 36, at 16; Appendix A-2.
39. *Id.*
40. Napier, *supra* note 33, at 233.
41. *Id.*
42. *Id.*

to track performance based on diversity characteristics. By collecting information about each investment manager's racial and gender make-up, the PPFs can compare performance of diverse managers versus performance of nondiverse managers. Second, asking for this information could send a signal to the investment firms themselves that PPFs are concerned about diversity. This message could be lighter or stronger depending on how the recipient of the information tends to interpret the importance of diversity, but it serves a baseline shaming function for investment managers that may have few to no minorities and women in its employee ranks, particularly in management and investment decision-making realms.

The latter point is important because while the specific targeted allocations to diverse managers influence only those managers who are a part of the defined category, these general RFPs that ask for diversity information from all applicants may influence the behavior of non-diverse, non-emerging managers. For example, a hedge fund run by mostly white men may find that after filling out numerous RFPs asking for diversity matrices, and after having to put down embarrassingly low numbers of women and minorities in its ranks, may choose to pay more attention to diversity recruiting within its own organization.

Second, CalPERS and CalSTRS have supported a third-party database of emerging managers. In 2006, for example, the two funds teamed up with a New York platform, Altura Capital, to allow emerging managers to join a database for free. The database would be available to a wide range of institutional investors.[43] The creation and promotion of more formal listings of diverse and emerging managers could have a number of effects. The first is that its information-sharing capabilities may make these managers more accessible to potential clients than ever before. Second, the database makes it easier for pensions and other institutions to easily track performance of these pools against other fund indices and to track the performance of a specific fund against the benchmark of the totality of listed diverse/emerging funds.

Thus far, I have described the myriad ways in which PPFs have taken steps to promote diversity in the financial sector. The traditional efforts were channeled into improving diversity on corporate boards. I have also laid out a different approach to diversity: that PPFs also direct efforts to hire diverse asset managers and to promote

43. *See CalSTRS and CalPERS to Build Emerging Managers and Financial Services Database*, CALSTRS (Apr. 17, 2006), available at http://www.CalSTRS.com/news-release/CalSTRS-and-CalPERS-build-emerging-managers-and-financial-services-database.

diversity in the asset management business. The following section explores what impetuses and rationales exist for these approaches to diversity.

## III. RATIONALES FOR PURSUING DIVERSITY INITIATIVES

Understanding the rationales behind PPFs' efforts to champion diversity is crucial not only to evaluating whether these practices are prudent investment practices for a steward of public monies, but also whether the practices are in fact legal.[44] Below, I identify and evaluate three likely rationales: a business case, a decision to pursue fairness and equality, and political or external pressures. These rationales are not necessarily competing, and different pensions may face different configurations of these forces.

### A. *Business Case Rationale*

One possible rationale is the business case for diversity promotion. If PPFs believe that corporations are likely to have higher earnings if they have board with more women and minorities, then the PPF will reasonably exert power as shareholders and institutional voices to push for more diversity on corporate boards. Similarly, if PPFs believe that investment funds run by women and minorities are more likely to outperform other managers, they would hire more of these investment funds to manage pension assets.

Pension funds do care about portfolio returns, even if it is not the only factor that influences their decision-making. Defined benefit public pensions are concerned about performance for several reasons. First, due to factors such as lack of influx of funding from state budgets, failure to match assets and liability durations, and losses in asset value due to market fluctuations, pension funds are severely underfunded. On an aggregate basis, U.S. public pensions have only a 38% fundedness ratio.[45] No state has a fundedness ratio higher than 54% (North Carolina), and some are extremely low (Illinois has a funded ratio of 24%).[46] While it is unrealistic to expect that asset performance alone will stave off the crisis in underfunded pension

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44. See *infra* Parts IV and V.

45. *See* Cory Eucalitto, *Promises Made, Promises Broken – The Betrayal of Pensioners and Taxpayers*, STATE BUDGET SOLUTIONS (Sept. 3, 2013), http://www.statebudgetsolutions.org/publications/detail/promises-made-promises-broken-the-betrayal-of-pensioners-and-taxpayers (referring to figures within the State Budget Solutions 50 State Pension Table); Appendix B.

46. *Id.*

funds,[47] there is strong pressure for the asset portfolio to perform as well as possible to prevent the gap from becoming even wider and to minimize the amount of capital the states have to raise to bridge the gap.[48] The interim issue is that taxpayers balk at having to make up shortfalls in pension funding, and the long-run issue is insolvency in paying out defined benefits to pensioners. In addition, the fact that some states are opting for the very unpopular option of cutting cost-of-living adjustments for payouts to pensioners – and facing legal action for doing so[49]– indicates that the financial pressures are very real.

Second, the pension industry as a whole is concerned by performance peer risk. On an institutional level, pensions get bad press when they underperform their peers, or underperform their benchmarks more severely than their peer funds. Because most institutional investors and specifically pensions have similar asset allocations, performance variations relative to peers becomes more salient to both the public and to trustees.[50] Pension fund performance is typically reported in headlines as Pension X "outperforms peers" or Pension X "lags behind peers."[51] Chief Investment Officers of pensions are risk averse, and their job performance sometimes cause them to be considered for positions at bigger, more prestigious funds, or can cause them to lose their jobs. Bonus payments to some pension investment professionals are sometimes tied to fund performance.[52]

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47. *See, e.g.*, Sage Um, *Illinois Pension Plan Blames Low State Contributions for Serious Underfunding*, AI-CIO.COM (Oct. 31, 2013), http://ai-cio.com/channel/REGULATION,_LEGAL/Illinois_Pension_Plan_Blames_Low_State_Contributions_for_Serious_Underfunding.html.

48. *See* Barry B. Burr, *Investments still Answer to Public DB Plan Underfunding Question*, PENSION & INV. (Oct. 17, 2011), http://www.pionline.com/article/20111017/PRINT/310179976/investments-still-answer-to-public-db-plan-underfunding-question

49. *See* Justus v. State, 337 P.3d 1219 (Colo. App. 2012), *rev'd*, Justus v. State, 336 P.3d 202 (Colo. 2014). The case against Colo. Public Employees Retirement Association was filed in 2010. First Am. Compl., Justus v. Colo., 2010-CV-1589 (Feb. 26, 2010 Colo.), *available at* http://saveperacola.files.wordpress.com/2010/01/2010-02-26-class-action-complaint.pdf.

50. *See* Simon Mumme, *Running with the Herd*, 18 INV. MAGAZINE 14 (2012); *The Obsession with Peer Risk*, ACTUARIES, 26-27 (Nov. 2012), *available at* http://www.actuaries.asn.au/Library/AAArticles/2012/Actuaries-NOV2012-WEB_P26-27.pdf; Scott Donald, *Prudence under Pressure* 20 (University of New South Wales Faculty of Law Research Series, Working Paper 10), *available at:* http://law.bepress.com/cgi/viewcontent.cgi?article=1152&context=unswwps-flrps09; Roger Urwin, *Sustainable Investment Practice*, Towers Watson Technical Paper No. 1656988, at 14 (Aug. 1, 2010), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1656988.

51. *See, e.g.*, Ted Nesi, *RI Pension Fund again Lags its Peers with Return of 11.1%*, WPRI.COM (Aug. 27, 2013), http://blogs.wpri.com/2013/08/27/ri-pension-fund-again-lags-its-peers-with-return-of-11-1/.

52. *See, e.g.*, Mark Niquette & Martin Z. Braun, *Texas Pension Manager Paid $1 Million Trails Peers Who Make Less*, BLOOMBERG (Dec. 12, 2012), *available at* http://www.bloomberg.com/news/2012-12-13/texas-pension-manager-paid-1-million-trails-peers-who-make-less.html.

Because portfolio performance is a priority for PPFs, it is worth examining how PPFs' diversity initiatives fit into the performance objective. First, I review existing literature on corporate diversity and earnings. Second, I turn to the practice of hiring diverse investment managers.

1. Effectiveness of Corporate Governance Diversity Initiatives

One hypothesis for the business case rationale is that the presence of women and minorities on corporate boards tends to increase profitability and/or stock values. There are two major strains of this hypothesis.[53]

One is that the women and minorities that would get promoted to positions on boards are on average more likely to make positive contributions to firm governance. This approach focuses on candidate-centric characteristics. For example, some studies suggest that women are better at financial risk management than men.[54] In addition, the experiences and networks of diverse groups could allow them to access better decision-making paradigms than homogenous groups can.[55] The second general thread of reasons to think that diversity enhances performance arises from believing there are positive interactive effects of having more women and minorities on the board. Specifically, some studies suggest that the presence of women on boards

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53. A number of potential rationales have been advanced; I am categorizing them here by the main principles underpinning them. For a more comprehensive review of individual factors, see, e.g., Lisa M. Fairfax, *The Bottom Line on Board Diversity: A Cost-Benefit Analysis of the Business Rationales for Diversity on Corporate Boards*, 2005 WIS. L. REV. 795, 839–40; Deborah L. Rhode & Amanda K. Packel, *Diversity on Corporate Boards: How Much Difference Does Difference Make?* 39 DEL. J. CORP. L. 377 (2014), *available at* http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1685615##.

54. *See, e.g.*, Brad M. Barber & Terrance Odean, *Boys Will be Boys: Gender, Overconfidence, and Common Stock Investment*, 116 QTRLY. J. ECON. 261, 285 (2001) (suggesting that women may be more risk averse than men); Chris Bart & Gregory McQueen, *Why Women Make Better Directors*, 8 INT'L J. BUS. GOVERNANCE & ETHICS. 93, 97-98 (2013) (finding that women directors scored higher on decision-making dimensions such as personal interest, normative, and complex moral reasoning). *See also* Elsa Ermer et al., *Relative Status Regulates Risky Decision Making about Resources in Men: Evidence for the Co-evolution of Motivation and Cognition*, 29 EVOLUTION & HUMAN BEHAVIOR 106 (2008); Nancy Ammon Jianakoplos & Alexandra Bernasek, *Are Women More Risk Averse? Attitude Toward Financial Risk*, 36 ECON. INQUIRY 620, 629 (1998); Katrin Bennhold, *Where Would We Be If Women Ran Wall Street?*, N.Y. TIMES, Feb. 1, 2009, http://www.nytimes.com/2009/02/01/business/worldbusiness/01iht-gender.3-420354.html?_r=0; Sheelah Kolhatkar, *What If Women Ran Wall Street?*, N.Y. MAGAZINE 36 (Mar. 29, 2010), *available at* http://nymag.com/news/businessfinance/64950.

55. *See, e.g.*, Nancy DiTomaso, Corinne Post, & Rochelle Parks-Yancy, *Workforce Diversity and Inequality: Power, Status, and Numbers*, 33 ANN. REV. SOC. 473, 488 (2007); Cedric Herring, *Does Diversity Pay? Race, Gender, and the Business Case for Diversity*, 74 AM. SOC. REV. 208, 208-09 (2009);

creates a positive effect on others on the board in being more thoughtful and prepared to make decisions,[56] and that women might exhibit better leadership skills in a board setting.[57]

A number of studies show that the presence of women is linked to higher profitability. For example, Catalyst, the gender-equity think tank, found that in a universe of Fortune 500 companies, those in the top quartile in terms of women on boards outperformed those in the bottom quartile on return on equity, return on sales, and return on invested capital.[58] A 2003 study found that racial and gender diversity on corporate boards was positively correlated with higher return on investments and return on assets.[59] A Credit Suisse study found that companies with women on boards had higher returns on equity and higher growth rates on average than companies without.[60] Moreover, a Thomson Reuters study suggests that across the globe, companies with more gender diversity on their boards were less volatile in performance than those without women on their boards.[61] These studies did not discuss whether racial diversity would also lead to similar findings.

Other studies, however, call into question the proposition that the presence of women and minorities on U.S. corporate boards tends to improve profitability.[62] In fact, though some argue that corporate diversity is good for business,[63] other evaluators – including Deborah Rhode – acknowledge the dearth of reliable empirical support for a causal inference.[64] Recent studies with broad-ranging datasets have also found a lack of relationship between corporate performance and the appointment of women and minorities to corporate boards. A

56. *See, e.g.*, Katherine Phillips, Gregory Northcraft & Margaret A. Neale, *Surface-Level Diversity and Decision-Making in Groups: When Does Deep-Level Similarity Help?*, 9 GROUP PROCESSES & INTERGROUP RELATIONS 476, 479 (2006).

57. *See, e.g.*, SCOTT E. PAGE, THE DIFFERENCE: HOW THE POWER OF DIVERSITY CREATES BETTER GROUPS, FIRMS, SCHOOLS, AND SOCIETIES 324-38 (2007); Frank Dobbin & Jiwook Jung, *Corporate Board Gender Diversity and Stock Performance: The Competence Gap or Institutional Investor Bias?* 89 N.C. L. REV. 809, 818-19 (2011); *Gender Diversity and Corporate Performance*, CREDIT SUISSE 18-19 (Aug. 2012); *Women Matter 2*, MCKINSEY & CO. 2 (2008).

58. Lois Joy et al., *The Bottom Line: Corporate Performance and Women's Representation on Boards*, CATALYST (Oct. 15, 2007), *available at* http://www.catalyst.org/system/files/The_Bottom_Line_Corporate_Performance_and_Womens_Representation_on_Boards.pdf.

59. Niclas L. Erhardt et al., *Board of Director Diversity and Firm Financial Performance*, 11 CORP. GOVERNANCE 102, 107 (2003).

60. *Gender Diversity and Corporate Performance*, *supra* note 57.

61. Andre Chanavat & Katharine Ramsden, *Mining the Metrics of Board Diversity*, THOMSON REUTERS 5 (Jun. 2013).

62. See Rhode & Packel, *supra* note 53, at 4-9, for a relatively comprehensive literature review.

63. *See, e.g.*, Letter from Anne Sheehan to Mark Zuckerberg, *supra* note 15.

64. *See* Rhode & Packel, *supra* note 53, at 10.

study of firms in the S&P 500 found that there was no significant relationship between gender and ethnic diversity on boards and the firm's return on assets or Tobin's Q (two frequently-used markers of a firm's financial performance).[65]

Furthermore, some studies have found *negative* relationships between increasing diversity on corporate boards and firm performance. In addition, there are studies that counter the heterogeneity-problem-solving narrative with one that describes the presence of diversity as cause for *inability* to reach solutions.[66] Others suggest adding women to boards may lead to over-monitoring that decreases firm performance.[67] For example, one study found that increases in gender diversity on U.S. corporate boards was negatively associated with Tobin's Q; the author also hypothesized that the decline in performance may be due to over-monitoring by women directors on boards.[68] Another study of Danish firms found a negative impact on performance in firms with female board members who are not elected by staff.[69] An interesting analysis by Dobbin and Jung presents a competing theory for slightly negative performance declines. They showed that gender diversity efforts were not followed by increased firm profitability in U.S. corporations, but later on, non-blockholding institutional investors decreased investments in these firms, which may have led to their slightly decreased stock values.[70]

In addition, a number of researchers have pointed out that the relationship between appointments of diverse boards and firm performance are not independent variables. Researchers dissecting data of U.S. corporate boards' found that the addition of women to boards is related to the number of women already on the board and the departure of a woman from the board previously.[71] They also found that women tend to serve on better performing boards, which indicates the

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65. David Carter et al., *The Gender and Ethnic Diversity of US Boards and Board Committees and Firm Financial Performance*, 18 CORP. GOVERNANCE 396, 411 (2010).

66. Elizabeth Mannix & Margaret A. Neale, *What Differences Make a Difference? The Promise and Reality of Diverse Teams in Organizations*, 6 PSY. SCI. PUB. INTEREST 31, 34 (2005).

67. Renee Adams & Daniel Ferreira, *Women in the Boardroom and their Impact on Governance and Performance*, 94 J. FIN. ECON. 291, 292 (2009).

68. *See* Adams & Ferreira, supra note 67, at 305-07.

69. *See* Nina Smith, Vlademar Smit & Mette Verner, *Do Women in Top Management Affect Firm Performance? A panel study of 2,500 Danish firms*, 55 INT'L J. PRODUCTIVITY & PERFORMANCE MGMT. 569, 588 (2006).

70. *See* Dobbin & Jung, *supra* note 57, at 828-29. This finding has interesting implications for Part C of this section, as I explore political motivations that partly drive behaviors of PPFs.

71. *See* Kathleen A. Farrell & Philip L. Hersch, *Addition to Corporate Boards: The Effect of Gender*, 11 J. CORP. FIN. 85, 94-95 (2005); *see also* Charles B. Shrader, Virginia B. Blackman & Paul Iles, *Women In Management And Firm Financial Performance: An Exploratory Study*, 9 J. MANAGERIAL ISS. 355, 359 (1997).

potential endogenous effects that pervade studies of this nature.[72] Thus, although it would certainly be convenient if diversity paid off for the bottom line, that conclusion is by no means firmly settled.

### 2. Effectiveness of Diverse and Emerging Manager Programs

Beyond exerting influence on corporate governance, PPFs also focus on diversity in its asset management arena. The rationales for believing that using diverse managers can help the PPF's bottom line are not the same as the business-case rationale for diversity in corporate governance. This section explores some potential rationales and presents evidence that, like in the corporate board diversity context, there is no reliable outperformance evidence for diverse and emerging managers.

#### a. Theoretical Basis for Performance Advantages of Diverse/Emerging Managers

It is possible that emerging managers might hold some unique benefits over larger, older funds. Some advantages of small, new funds include: 1) smaller AUM funds can invest in positions without trading costs such as market impact, fast implementation, front running, etc., 2) smaller funds can sell out of positions much more quickly than large funds can, 3) smaller AUM funds can invest in full positions without sacrificing liquidity problems, 4) the ability to take smaller positions means these funds can exploit opportunities too small for larger funds to tap into, 5) by not hitting constraints in the size of their trades, smaller funds can focus on their very best trading ideas and thereby escape the need to trade in strategies outside their core expertise, 6) smaller and newer hedge funds have a greater motivation to succeed because oftentimes personal money is at stake and because they have less of a reputational cushion to fall back on.[73]

Rationales for the performance advantages of diverse managers, however, would have to be more attenuated. Some research suggests

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72. *See* Farrell & Hersch, *supra* note 71, at 104; Shrader et al., *supra* note 71, at 365. It is also possible that women may be appointed to boards facing previous poor performance. *See* Michelle K. Ryan & S. Alexander Haslam, *The Glass Cliff: Evidence that Women are Over-Represented in Precarious Leadership Positions*, 16 BRIT. J. MGMT. 81, 83 (2005).

73. *See, e.g.*, *Emerging Manager Programs: A Best Practices Overview*, *supra* note 22, at 3. Sandra Parker et al., *PCA Research Brief: A Review of Developing Managers and Developing Manager Programs*, PENSION CONSULTING ALLIANCE, INC. 1 (Jul. 2003), *available at* http://www.pensionconsulting.com/Portals/0/UserReports/A%20Review%20of%20Developing%20Managers.pdf; Rajesh K. Aggarwal and Philippe Jorion, *The Performance of Emerging Hedge Fund Managers* 3-4 (AFA 2009 San Francisco Meetings Paper, Jan. 23, 2008) *available at* http://ssrn.com/abstract=1103215.

that "emerging manager" and "diverse manager" have overlapping results, because historically and today, these minority and women-owned investment managers tended to also "[fall] below investor thresholds within mainstream investment consultant manager universe databases."[74] Yet emerging managers and diverse managers do not always have overlapping characteristics. A 2013 CalPERS report showed that 9% of external managers across the pension fund were diverse, and 19% of the emerging managers are diverse.[75] On an AUM basis, 9% of the total fund external management capital was invested with diverse managers, and 32% of the emerging manager capital was with diverse managers.[76] In other words, emerging managers were more likely to be diverse than managers in the portfolio overall. But the bottom line is that the vast majority of emerging managers by number and by AUM in the CalPERS portfolio were not diverse managers. Some diverse managers are neither new managers nor small managers. Some small and new managers are not diverse.

We already know that small AUM and relatively new tenure might carry some advantages, as explicated above. But PPFs might be interested in advantages that are unique to the identity of the fund owners and managers themselves. For example, there are some organizational management theories suggesting that women may be better money managers than men because they are less likely to take on undue risk.[77] Other possible reasoning include the idea that funds headed by minorities can access capital and opportunities in communities populated by these minorities, would may not have been available to funds managed by white managers. This could be particularly salient in private equity and infrastructure investments, where the relationship between the fund manager and the investment opportunity is more organic and face-to-face than trading relationships between portfolio managers and traders behind a Bloomberg terminal. Finally, it is possible that strategies by nontraditional minority money managers could tap into uncorrelated return streams, which, even if not outperforming on returns, could add diversification to the portfolio overall and lower risk.

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74. *Emerging Manager Programs: A Best Practices Overview*, *supra* note 22, 2-3.

75. *Emerging & Diverse Manager Data Report*, CALPERS 5 (Mar. 2013), *available at* http://www.CalPERS.ca.gov/eip-docs/about/pubs/data-report.pdf.

76. *Id.* at 6.

77. *See* Barber & Odean, *supra* note 54, at 283-84.

#### b. Empirical Evaluation of Diverse/Emerging Manager Performance

It is uncontroversial that pension funds generally seek managers who are most likely to deliver higher performance at lower risk. However, no reliable study demonstrates that investment funds managed or owned by minorities and women tend to outperform their counterparts. There has not been a robust comparison of these diverse managers' relative performance. Research on emerging managers – categorized based on size or age of the fund – showing some performance advantages tend to not be performed by independent, peer-reviewed studies. Thus, whether emerging or diverse managers tend to outperform their traditional counterparts is far from settled in empirical studies and in the realized experience of investors. The following exchange between Orim Graves, the Executive Director of the National Association of Securities Professionals and the CalPERS CIO Joe Dear at the CalPERS Emerging Manager Forum in December 2012 is particularly telling:

> Orim Graves: So I think from the mindset of how you kind of approach the emerging manager, diverse manager sector, is one that should look at it not as, not as much of a chance as it is a, probably a good bet to make that investment . . . . Is that correct?
>
> Joe Dear: It's mixed. It's mixed Orim. It's not a slam across the board success.[78]

In fact, in a March 2013 comprehensive report comparing the historical performance of the CalPERS Emerging Manager portfolio with that of the rest of the portfolio concluded that

> Performance of emerging managers varies, and based on CalPERS experience, we cannot draw a broad conclusion about performance of emerging managers . . . . As a group, emerging managers outperformed non-emerging managers in certain asset classes and underperformed non-emerging managers in others.
>
> Similarly, performance of woman and minority owned managers was mixed across the asset classes. This is consistent with CalPERS experience with non-emerging and non-women and minority-owned managers. There is typically significant dispersion of performance across managers and strategies in the CalPERS investment portfolio.[79]

Even within the emerging manager category, the results are mixed. One study found "no broad-based differences in investment perform-

78. Transcript Part 2 of General Session at 13, CalPERS Emerging Manager Forum (Dec. 3 2012), *available at* http://www.CalPERS.ca.gov/eip-docs/investments/general-session-part-2.pdf [hereinafter Transcript Part 2].

79. *Emerging & Diverse Manager Data Report*, *supra* note 76, at 5.

ance or investment risk between developing and mainline managers" of domestic equities.[80] Other studies have elicited some strands of evidence to show that "young" investment funds tend to outperform their larger, more conventional counterparts. For example, a study by Investcorp, an alternative investment manager, found that emerging managers outperformed their larger counterparts by 130 basis points per year at lower risk.[81] Another unpublished study, by academic researchers at the University of Minnesota and the University of California, also reported outperformance by newer funds relative to their more established peers.[82] The authors of these studies acknowledged that there is risk of bias because many emerging managers only begin reporting their returns to tracking databases when the returns are good.[83] They attempt to account for this "backfill bias" by eliminating pre-reporting date returns or by only considering funds whose inception date was the same as their initial reporting date.[84] However, even these measures will still result in over-reporting the performance of nascent funds, because of the funds that never report their performance or go belly-up before having good enough returns to want to report. In other words, while studies can account for backfill bias to a certain extent, they cannot account for survivorship and sampling bias. Ultimately, there just are not enough studies that rigorously evaluate the performance of emerging and diverse managers.

c. Business Case Rationale in Light of Uncertainty

Given the lack of definitive evidence, one might conclude that there is *no* "business case rationale" for emerging and diverse manager programs. However, it is still possible that performance-based justifications could figure into the PPFs' calculus. I explain how by charting through three scenarios for how PPFs might think through the issue.

In one scenario, PPFs believe that their traditional methods of evaluating managers: soundness of investment strategy, diversified return stream, long record of good historical performance, large institutional asset base, and ability to provide in-house operational and logistical services, are the best methods for evaluating whether to hire a manager. Under this scenario, PPFs would not rationally pursue emerging manager and diversity manager programs, which might not be able to

80. *See* Parker et al., *supra* note 73, at 10.

81. Deepak Gurnani, Ludge Hentschel, & Nirav Shah, *Emerging Hedge Funds: A Source of Alpha*, INVESTCORP, 9, 14 (Oct. 2010), *available at* http://u15474470.onlinehome-server.com/lib/docs/112202-emerginghedgefundsfinal.pdf.

82. Aggarwal & Jorion, *supra* note 74, at 30.

83. Deepak Gurnani et. al., *supra* note 81, at 13.

84. *Id.*

meet those parameters. Those funds that do meet the parameters would be found in traditional search, but of course, this approach does not explain the behavior of PPFs engaged in nontraditional searches for managers: namely, those who are searching for emerging and diverse managers instead.

In a second scenario, PPFs believe that there are unique merits to emerging and diverse funds. For example, they may believe that minority managers are more likely to deliver uncorrelated return streams that decrease risk in the overall portfolio. They may believe in restrictions on fund size, AUM, and traditional pipelines for fund names are artificial constraints that might cause some outperforming funds to be overlooked. These PPFs would rationally pursue the strategy of lifting those restrictions from their manager selection process. So if a PPF were persuaded that smaller funds are better able to access investment opportunities, they could simply remove the AUM restriction on their RFPs for certain asset mandates, and smaller funds could apply. PPFs could even allow smaller funds to pool into ad-hoc groups to access larger mandates. This way, the best and most attractive asset managers regardless of AUM, age, and name recognition/identity could win RFPs.

But under this scenario, it is difficult to see why these PPFs would want to create separate programs to block out *bigger, more established* funds from competition. However, some PPFs currently run their Emerging Manager programs as a restricted set-aside model, where only these Emerging Managers could participate. This suggests that PPFs do not follow the second scenario's line of thinking.

Finally, under a third scenario, the PPFs might be *uncertain* about the merits of some of the issues described above.[85] For example, they may think that sometimes smaller funds can trade in and out of positions more nimbly, but they prefer the stability of a larger fund that has handled large institutional assets. They may think that women-headed investment firms are better at times of crisis, but may not be so sure in this belief. Thus, they created emerging managers and diverse manager programs to experiment, and in so doing, need to present positive, definitive justifications for their doing so (it simply does not sound good to say, "these programs *might* be good, so we are trying them out.") Of course, this might not be a completely rational strategy for a profit maximizing organization. However, when com-

85. Despite the lack of solid empirical data showing the performance benefits of emerging and diverse managers, it is not surprising that PPFs have nevertheless lauded these funds for presenting attractive investment opportunities. After all, these institutional investors must advance some rationales for investing in these nontraditional external managers.

bined with other potential political or equity-based advantages, this approach might be enough for some institutions to give diversity a try.

### 3. Size of Business Case Impact

Finally, even if there were some grounds to believe that diversity promotion is good for business, a subsequent, more difficult question is "how good"? Results are difficult to quantify when it comes to efforts to promote corporate board diversity. The result of a preference to vote for diverse candidates only goes so far as there are plausibly qualified board candidates available, that there are no other intervening factors that would drive the funds to vote otherwise, and that other voters would not overwhelm the power of PPFs as shareholders. On the lobbying front, it is unclear how much the PPFs' efforts contributed to the SEC's successful passage of the diversity statement rule, nor is it clear that simply requiring companies to disclose how they take diversity into account in board selection will yield a different board composition. Finally, the support for third parties could be influential, but only insofar as these third parties are successful in actually catapulting diverse candidates into positions on boards, and whether the contributions to the cause are sufficient.

On the investment management front, however, the level of consequence visited by having an emerging – diversity manager program is more quantifiable. After all, investment managers are typically measured based on their performance, i.e. whether they have generated adequate return at a suitable level of risk. The inclusion of some managers that are not selected solely based on the pure potential to maximize Sharpe Ratio could be viewed as negatively consequential. However, as the aforementioned analyses suggest, there is no specific study pointing to significant underperformance by emerging and diverse managers. Thus, though it is perhaps possible to identify just how much emerging and diverse managers contribute to or detract from performance, we have no tools to do so.

Thus, for different reasons, we are unable to answer the question of just how consequential is it for PPFs' bottom line to pursue these diversity initiatives. With that, we turn to other potential justifications for doing so.

### B. *Equality-Based Rationale*

PPFs might also want to pursue diversity initiatives because they believe equality is inherently desirable.[86] In this section, I explore evidence that PPFs are interested in rectifying inequality. There are two different - though by no means mutually exclusive - approaches. First, PPFs may believe that there is a need to remove discriminatory barriers in the investment manager search process. The cause of the discrimination can come in a number of ways. The most broad-based version is the belief that women and racial minorities are less likely to enter the financial industry and specifically the asset management industry because of societal factors: overt discrimination, lack of role models, or signals that direct women and minorities away from these careers or leadership roles within that career.

The casual story can also be told through a structuralist lens. For example, if access to capital and access to leadership positions tend to rest within the hands of those who already have power, then it follows that corporations tend to be run by white men. They had access to the positions and opportunities that can make someone both "board ready" and well-known to other voters. In the asset management context, large, established funds that already are well known and have tapped into institutional capital bases have an easier time getting institutional clients. A fund run by a white, male, Harvard Business School graduate that began in the early 1990s is more likely to have access to capital based on "who" the fund is. Investors may be focused on the performance of the fund, but may have selected it over lesser-known but equally good performers. On the other hand, a fund launched last year by a talented Latina in New Mexico could be quite good if it were given enough capital and opportunity to succeed, but may not ever be able to do so because it never had the opportunity. The Illinois State Pension Board made a note of this approach in the fund's Investment Policy, explaining that

> [E]ven large, experienced and successful investment organizations were once small, start-up firms with few assets under management. Today many such firms are owned by minorities, women and persons with a disability. These firms are often started by experienced investment professionals, who show great promise, but find it difficult to compete with large majority owned organizations.[87]

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86. See Fairfax, *supra* note 5, for a discussion of the shift from the equality-based rationale to a business-based rationale. David B. Wilkins, *From "Separate Is Inherently Unequal" to "Diversity Is Good for Business": The Rise of Market-Based Diversity Arguments and the Fate of the Black Corporate Bar*, 117 HARV. L. REV. 1548, 1553 (2004).

87. ILL. STATE BD. OF INV., INV. POL'Y 68 (last amended Dec. 5, 2014), *available at* www.illinois.gov/isbi/Documents/Investment-Policy.pdf.

The second approach to the equality rationale focuses not on the causal story but rather on the *implications* of the reality of underrepresentation. PPFs have expressed a desire to have the managers of pension assets be closer aligned with the racial and gender demographics of the underlying pensioner communities. In other words, there may be a keen sense that white men should not control the future financial fates of pension beneficiaries of different races and genders. A similar rationale is probably used for choosing the board of trustees for pension funds, who are rarely as uniformly white and male as the investment community. For example, CalSTRS released a report on the history of its diversity-seeking efforts, noting that

> Historically, teaching has been a progressive profession where women have enjoyed a rich stronghold and where diversity has been fully embraced. However, the investment management industry has not been as far along in its development as educators; it has been bound by traditional ways and beliefs. Thus, diversity in the management of investments is a concept that has gained momentum and has been more prevalent in recent years, partly due to the change in demographics in the United States and partly due to forward-thinking leadership.[88]

As this account reveals, there is cache in the idea that the demographic composition of a particular institution should set some expectations for the composition of the group that is tasked with leading, managing, or implementing policies and outcomes. As Henry Jones, the Chair of the CalPERS Investment Committee, stated at a public conference, "As the largest public pension fund in the nation, within the nation's most ethnically and culturally diverse state, we can't reach our full potential without having the broadest pool of talent to work with."[89] Jones's remarks once again imply that there is something special about the demographic diversity of California public employees that makes it even more important for the pension to pursue diversity initiatives. It could be seen as a democratic mandate, or a sort of an effort to avoid delegitimization. This theory is less connected to discriminatory practices, but rather focuses on the underrepresentation outcomes.

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88. *Semi-annual Report on Diversity in the Management of Investments*, CALSTRS 1 (Nov. 1, 2007), *available at* http://www.CalSTRS.com/sites/main/files/file-attachments/diversity_investments_mgmt.pdf.

89. Transcript Part 1 of General Session at 3, CalPERS Emerging Manager Forum (Dec. 3 2012), *available at* http://www.CalPERS.ca.gov/eip-docs/investments/general-session-part-1.pdf [hereinafter Transcript Part 1].

Even though these two rationales are social-justice based, they may envelop an embedded performance concern as well. Because smaller and minority-owned funds have a harder time accessing pools of capital, having set-aside incubators for them could reap great rewards when some of them ultimately succeed based on that initial grant. In other words, opportunity begets more opportunity, and PPFs are offering a sliver of opportunity to those who may be able to seize it and build on it. As long as the reward of enabling the success of some diverse and emerging managers who otherwise would *not* have made it outweighs the overall costs of running an emerging and diverse manager program, it may still be worth it from a "performance" perspective for PPFs, particularly larger ones, to pursue these initiatives.

Of course, some are "displeased that these emerging managers receive preferential treatment."[90] Skeptics of emerging and diverse manager programs would argue that opportunities to invest should be based on track records and parameters grounded in investment strategy evaluations, not on future hopes of future success. However, as the next section shows, there may be countervailing political pressures to offset these criticisms.

### C. *Political Pressures*

A third reason for PPFs to pursue diversity initiatives may be due to external political pressures. In other words, even if there is no business case for diversity, nor do the funds firmly believe in promoting diversity as a justice-based imperative, they may still be motivated to do so because other forces propel them to do so.[91]

There is some evidence that political pressure constitutes a part of the impetus to pursue diversity manager programs. Some of this pressure manifests in legislative action, as several states have passed legislation promoting "emerging" managers, some with explicit mandates to consider diversity. Three states that adopted legislation did so with a strong, explicit aim to increase diversity. Maryland's House Bill 1277, which passed unanimously in 2008, stipulated that the Boards of Trustees of various state funds, including the State Retirement Pension System, "direct the Investment Committee to attempt to use the

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90. *See* Ashby Monk, *Why Asset Management Needs More Emerging Manager programs*, INSTITUTIONAL INVESTOR (Oct. 16, 2012, 11:30 AM), http://www.institutionalinvestor.com/blogarticle/3103927/why-asset-management-needs-more-emerging-manager-programs.html.

91. *See, e.g.*, John Entine, *The Politicization of Public Investments*, *in* PENSION FUND POLITICS: THE DANGERS OF SOCIALLY RESPONSIBLE INVESTING 1, 3-7 (John Entine ed. 2005) (providing a number of examples of politically motivated pension investment decisions); Roberta Romano, *Public Pension Fund Activism in Corporate Governance Reconsidered*, 93 COLUM. L. REV. 795, 803-08 (1993) (describing a number of politically-driven public pension investment decisions).

greatest extent feasible minority business enterprises to provide brokerage and investment management services to the board."[92] The bill was remarkable for its attempt to *maximize* minority manager participation. It was sponsored by members of the Maryland legislature's Black Caucus, and was unanimously passed.[93]

Another example of potential political pressures at play is California. While one might expect Californian funds to be subject to pressure *against* diversity initiatives given that a 1996 voter referendum, Proposition 209, amended the state constitution to prohibit the state from considering gender, race, and ethnicity in public contracts and employment,[94] California's funds as a whole are some of the biggest supporters of diversity initiatives generally. Both CalPERS and CalSTRS have been pioneers in the development of emerging manager platforms.

California's statutes on Emerging Managers do not consider race and gender explicitly. California's 2011 Senate Bill 294 required that the boards of CalPERS and CalSTRS create a "five-year strategic plan for emerging investment manager participation across all asset classes," and that the boards submit annual reports to the legislature.[95] The reason that California statute does not specify minority status as a qualification for its emerging manager program is that Proposition 209 prevents it from doing so.

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92. *See* MD. CODE. ANN., STATE PERS. & PENS. § 21-116(d)(1)(i) (2008).

93. *Id.* Illinois passed a similar law in 2009 to increase the utilization of emerging managers, which are defined by both size and owner (minorities, women, or individuals with disabilities). 40 ILL. COMP. STAT. 5/1-109.1 (2012). In 2010, New York also updated its Retirement and Social Security Law to renew a commitment to minority businesses in the pension context. N.Y. RETIRE. & SOC. SEC. § 423-c (Consol. 2010). The Illinois statute does not in itself mandate a minority manager program, but rather leaves it to the "discretion of the state comptroller." *Id.* However, it lists out a number of possibilities for increasing "utilization of MWBE asset managers" and other financial firms. *Id.* For asset managers, it includes "allocating investments of assets of the common retirement fund either through: (i) direct investments in the equities and debt securities of MWBEs; or (ii) indirectly through special programs involving MWBE asset managers." *Id.* at 423-c.1.(c).

94. Proposition 209: Prohibition Against Discrimination or Preferential Treatment by State and Other Public Entities. Initiative Constitutional Amendment (Nov. 5, 1996), *available at* http://vote96.sos.ca.gov/BP/209.htm (enacted as CAL. CONST. art. I, § 31). "The state shall not discriminate against, or grant preferential treatment to, any individual or group on the basis of race, sex, color, ethnicity, or national origin in the operation of public employment, public education, or public contracting." CAL. CONST. art. I, § 31(a).

95. CAL. EDUC. CODE § 22228 (2011). California's precise definition of "emerging manager" is left up to the investment boards, but Proposition 209 precludes explicit accounting for race. *See* CAL. CONST. Art. I, § 31. Thus, the definition generally must be along lines of size and age of the fund.

Notwithstanding Proposition 209,[96] there is significant political pressure in California to continue promoting diversity initiatives. For example, CalPERS and CalSTRS came under fire by diversity organizations after scaling back its emerging manager programs in private equity. In 2012, supporters of the Toigo Foundation, which is dedicated to promoting diversity and has had a longstanding relationship with CalPERS, wanted to remove the fund's CIO from the annual gala program because of their dissatisfaction with CalPERS's failure to pay more attention to emerging and diverse managers. One report of the tensions noted that "Many emerging managers believe CalPERS is withdrawing its support for the segment - preferring instead to write bigger cheques for the larger, top-performing managers who can offer a better deal on fees" and that they believe "CalPERS' commitment to the strategy is waning."[97] The managers complained that the fund had declined reinvestment in these funds and further communication about its decisions. This led to special hearings of the California state senate "in part to investigate the perception that the pension system had been inequitable in its manager selection."[98] During the meetings, CalPERS CIO Joe Dear reiterated the fund's commitment to diversity. However, the fund noted in a later report that the performance of emerging managers was not positive across the board, and the same was the case for diversity managers.[99]

These exchanges indicate that the PPFs must walk a delicate line while three forces bear upon its decision-making. First: being responsive to the demands of the community of diversity stakeholders, second: bringing home high returns for pensioners, and, to the extent necessary, third: abiding by state restrictions on explicitly considering race or gender (for example, Proposition 209's parameters). The restraints created by Proposition 209 certain bring the California funds close to the juncture of the community demands. At a conference in 2012 that included members of the California legislature, the influen-

96. Proposition 209 is here to stay unless the voters of California reverse their position. The Supreme Court has upheld a similar ballot initiative in Michigan in Schuette v. Coalition to Defend Affirmative Action, 134 S. Ct. 1623 (2014). *See, e.g.*, *State Proposal – 06-2: Constitutional Amendment: Ban Affirmative Action Programs*, MICH.GOV, http://miboecfr.nictusa.com/election/results/06GEN/90000002.html (last visited Mar. 12, 2014). The language is the same as California's Proposition 209. See MICH. CONST. art. I, § 26(2). Other states have successfully instituted similar programs, including Washington State's Initiative 200 (Dec. 3, 1998), the One Florida Initiative (Feb. 22, 2000) and Nebraska's ban of affirmative action on both racial and gender lines via Initiative 424 (Nov. 4, 2008).

97. Christopher Witkowsky, *CalPERS' emerging manager problem*, PRIVATE EQUITY INT'L 1, 4 (Oct. 12, 2012).

98. *Id.* at 6.

99. *Emerging & Diverse Manager Data Report*, *supra* note 75, at 5.

tial Toigo Foundation, and other diversity lobbyists,[100] CalPERS CIO Joe Dear made the following statement:

> [A]s all of you in this room know, CalPERS has to work within the confines of California's proposition 209. That means we cannot establish goals or targets for placement of external investment based on race, ethnicity, color or gender. That makes management of these programs more difficult, because if you're managing and you have a goal, you know what you're kind of doing.[101]

Dear continued to explain that the reason attention to California's Emerging Manager program work is because statistically speaking, promoting the pool of emerging managers will inevitably promote minority managers within that pool. "[D]iverse managers make up a greater proportion of the emerging manager community than they do in the overall investment manager community," he stated. "For this reason, we remain committed and confident that we can meet the expectations of the diverse manager community by focusing on emerging manager programs, and stay within the confines of California law."[102]

Thus, though it may be the case that individual pension fund managers – and perhaps even some investment committees and boards – may not otherwise be driven to promote diversity, the pressure of political forces push some funds toward that direction. That political pressure need not literally come from the legislature, but as the California example demonstrated, there is a certain degree of commitment accountability that public pension funds face. This is consistent with the Dobbins and Jung finding that institutional investors are gender-biased, but that appearances ("accountability apprehension") will "mediate" the process. Their specific finding on this issue is that empirically, investors decrease holdings in a company if females are appointed to board *unless* they believe they will be held politically accountable for such actions. In the PPF diversity manager context, the legislature, lobbyists, and other third parties all serve as "accountability" agents that steer funds toward pursuing diversity initiatives, against the countervailing pressures of performance results and anti-affirmative-action measures.

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100. Including the National Association of Security Professional, the New America Alliance, the National Association of Investment Companies; the Association of Asian American Investment Managers; the California Legislative Black Caucus, the California Latino Legislative Caucus, and the California Asian Pacific Islander Legislative Caucus. See *2012 Forum Archive*, CALPERS (last accessed Apr. 22, 2014), http://www.CalPERS.ca.gov/index.jsp?bc=/investments/targeted-programs/2012-archive.xml.

101. Transcript Part 1, *supra* note 89, at 8.

102. *Id.*

## IV. CONSTITUTIONAL IMPLICATIONS OF PURSUING DIVERSITY: THE "STRICT SCRUTINY STRAIGHTJACKET"

Even if PPFs make decisions to pursue diversity hiring initiatives in light of uncertainty about performance outcomes, they also face another external uncertainty: whether they will get sued for doing it. In this section, I contend that there are serious legal risks to states' diversity-promotion programs. This issue is most significant for the hiring of minority asset managers to invest PPF funds. Though to date there do not appear to have been any litigations against pension funds on the grounds that their diverse manager programs may violate Equal Protection Clause, I argue that these programs as they currently stand are at risk of demise when reviewed under the Supreme Court's current affirmative action jurisprudence. While these programs might promote positive social change, the means of the attempt may render their project danger. Thus, even supporters of diversity initiatives should be concerned about the existential risks for these programs given current Supreme Court jurisprudence.

The Supreme Court's review of race-based affirmative action programs focuses primarily on two areas: education and government contracting. In those two areas, it has recognized "two interests that qualify as compelling": diversity in higher education, and remedying past discrimination.[103] Though attention to education has overwhelmed affirmative action discourse in the past decade or so, the Court's government contracting jurisprudence is directly applicable to PPFs' diversity manager programs. That jurisprudence is not so favorable to these programs. The Court has held that the standard of review for all race-conscious government actions, whether insidious or remedial, is that of strict scrutiny. Both state and federal government contracting programs are subject to this standard, according to *City of Richmond v. J.A. Croson Co.*[104] and *Adarand Constructors, Inc. v. Pena.*[105] Diverse manager programs face significant constitutional hurdles. As Justice Marshall warned in his dissent in *Croson*, the majority's application of strict scrutiny to all race-conscious state action outfits a "strict scrutiny straitjacket" on states and localities seeking to implement minority hiring programs.[106]

103. Parents Involved in Cmty. Sch. v. Seattle Sch. Dist. No. 1, 551 U.S. 701, 720-22 (2007). Other interests, such as the "role model" theory, were rejected. *See* Wygant v. Jackson Bd. of Educ., 476 U.S. 267, 274–76 (1986). Still others, like racial isolation, have not been fully confirmed or rejected. *See* Fisher v. Univ., 133 S. Ct. 2411, 2418 (2013); *Parents Involved*, 551 U.S. at 788 (Kennedy, J., concurring).

104. City of Richmond v. J.A. Croson Co., 488 U.S. 469 (1989).

105. Adarand Constructors, Inc. v. Pena, 515 U.S. 200, 205 (1995).

106. *Croson*, 488 U.S. at 555 (Marshall, J., dissenting).

In this Part, I first explain why PPF diversity programs are race-based classifications subject to constitutional scrutiny. Then, I provide a brief history of the development of the law of affirmative action and the prevailing standard of review. Next, I provide a detailed analysis of the current standards that government race-conscious contracting programs must meet to satisfy constitutional requirements. Because courts might use an array of empirical evidence to make decisions about remedial measures, thereby creating a great deal of uncertainty over what a program needs to show to pass constitutional muster, I map out a matrix of past standards that have been used. Finally, I apply those standards to PPF funds. I conclude that the difficult criteria promulgated by strict scrutiny review, when applied to PPFs' diverse manager programs suggest that these initiatives face serious risk of failing constitutional review should they be challenged in court.

### A. *PPF Diversity Programs as Race-Conscious State Action*

Whenever a public pension fund puts out a search for a minority-owned investment manager, it triggers strict scrutiny, because it has taken a state action that classifies on the basis of race. This is so regardless of how the statute is written, or if there is a statute at all. According to *Croson* and *Adarand*, all government programs that use racial classifications must be subject to strict scrutiny. In short, when a PPF hires a minority asset manager, that relationship is one akin to the City of Richmond in *Croson* hiring contractors who use minority subcontractors.[107]

Diverse manager programs like the ones in Maryland, Illinois, and New York arise from legislative action that categorize on the basis of race and gender. For example, the Maryland law states:

> Consistent with minority business purchasing standards applicable to units of State government under the State Finance and Procurement Article and consistent with the fiduciary duties of the Board of

107. The argument that the PPF-asset manager relationship is one between a government employer and employee fails. First, the fund itself is not an employee of the government; neither are the fund's employees. No employment contract exists; rather, a contract on services is drawn up. Second, in the aftermath of some recent corruption scandals, such as pay-to-play schemes involving pension funds, New York State now mandates that investment managers seeking to influence procurement (even for themselves) would have to register as third-party lobbyists. *See* Letter from Michael A. Cardozo, Corp. Counsel, City of N.Y. Law Dep't, to the Honorable Michael McSweeney, City Clerk, 5-6 (Mar. 31, 2010), *available at* http://www.cityclerk.nyc.gov/downloads/pdf/placmentagents.pdf. In any case, courts have also used the *Croson* and *Adarand* analysis for government remedial actions that do not involve contracting, including for contexts like building public housing units, *see, e.g.*, Walker v. City of Mesquite, 169 F.3d 973, 982 (5th Cir. 1999), and government hiring practices, *see, e.g.*, Rutherford v. City of Cleveland, 179 F. App'x 366, 375-76 (6th Cir. 2006).

> Trustees, the Board of Trustees shall direct the Investment Committee to attempt to use to the greatest extent feasible minority business enterprises to provide brokerage and investment management services to the Board.[108]

Minority business enterprises are defined in Maryland as legal entities that are "at least 51% owned and controlled by one or more individuals who are socially and economically disadvantaged," as well as managed by one of these owners.[109] "Socially and economically disadvantaged" people are in turn defined as "a citizen or legal U.S. resident who is African American, Native American, Asian, Hispanic, physically or mentally disabled, a woman, or otherwise found by the State's MBE certification agency to be socially and economically disadvantaged."[110]

As the above language indicates, the law triggers racial classifications. These statutes were not passed without notice of the risk that they may trigger racial classification. In a letter addressed to Maryland Governor Martin J. O'Malley, the Maryland Attorney General Douglas Gansler discussed this exact issue. The letter stated that the Maryland Attorney General interpreted the term acting "consistent with minority business purchasing standards" to be not the same as making the funds "actually . . . subject to those provisions."[111] It cites a state lower court case that interpreted "consistent with" in the confines of a local zoning law as not entirely requiring compliance. This, the Maryland Attorney General states, means the bill should not be read to employ race-conscious action.[112] The letter also argues that because the bill instructs the Maryland investment funds to act within their fiduciary duties, which would "include avoiding action likely to lead to meritorious action against the funds."[113]

Both arguments are almost certain to fail. First and most importantly, the practical effect of following the law's demand is for the individual funds to put out RFPs that search for minority managers, which in itself is a state action that categorizes on the basis of race. The threshold inquiry of racial classification here triggers strict scrutiny and all its attendant inquiries. Second, the interpretation of the

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108. MD. CODE ANN., STATE PERS. & PENS. § 21-116(d)(1)(i) (2012).

109. *Fiscal and Policy Note SB 06: State Government – Brokerage and Investment Management Services – Use of Minority Business Enterprises,* MD. DEP'T OF LEGISLATIVE SERVS. 3 (2008), *available at* http://www.mwbeunited.org/PDFs/Maryland-SenateBill606.pdf.

110. *Id.*

111. Letter from Douglas F. Gansler, Attorney General of Maryland, Office of Counsel to the General Assembly, to The Honorable Martin J. O'Malley, Governor of Maryland, 2 (May 15, 2008).

112. *Id.* at 3.

113. *Id.* at 2.

term "consistent with" as not *required* seems unlikely to hold water, especially when the bill also *requires* the funds to produce reports showing progress in minority business utilization.[114] It is not plausible to argue that an agency that is not "actually . . . subject to those provisions" must also produce progress reports to show how much progress it has made on "those provisions." Third, the argument that including the phrase "*consistent* with the fiduciary duties" would preclude race-conscious actions ironically contradicts the Attorney General's first argument that the word *consistent* with" does not mean "subject to." Finally, the argument that the funds' acting consistent with fiduciary duties would mean they would not take any race-conscious action is a logical fallacy that simply begs the question. Unless the Attorney General is suggesting that the funds do not take any race-conscious actions at all out of fiduciary duty (which would make the law itself a dead letter), the argument that the moniker "fiduciary duty" could automatically free a race-classifying statute from constitutional scrutiny will not go far. The Attorney General's letter admits that, "Read literally, the requirement that the agencies use minority business enterprises 'to the greatest extent feasible,' would require that an MBE be favored in contracting regardless of the qualifications of other bidders[.]"[115] It then adds that under such a reading, it would be impossible for the law to survive strict scrutiny.[116]

The Illinois statute also triggers a race-based classification. Its "emerging manager" program applies to funds between $10 million and $10 billion in assets "and is a 'minority owned business,' 'female owned business' or 'business owned by a person with a disability' as those terms are defined in the Business Enterprise for Minorities, Fe-

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114. MD. CODE ANN., STATE PERS. & PENS. § 21-116(d)(4) (2012). The bill states specifically:

> On or before September 1 each year, the Investment Committee shall submit a report to the Board of Trustees, the Governor's Office of Minority Affairs and, subject to § 2-1246 of the State Government Article, the General Assembly on:
>
> (i) the identity of the minority business enterprise brokerage and investment management services firms used by the Investment Committee in the immediately preceding fiscal year;
>
> (ii) the percentage and dollar value of the assets that are under the control of the Investment Committee that are under the investment control of minority business enterprise brokerage and investment management services firms for each allocated asset class; and
>
> (iii) the measures the Investment Committee undertook in the immediately preceding fiscal year in accordance with paragraph (2)(ii) of this subsection.

*Id.*

115. Letter from Douglas F. Gansler to The Honorable Martin J. O'Malley, *supra* note 111, at 2.

116. *Id.* (describing why it would not pass compelling state interest or narrow tailoring tests).

males, and Persons with Disabilities Act."[117] Pursuant to that definition, the current law for emerging managers in Illinois pensions and other funds states:

> It is hereby declared to be the public policy of the State of Illinois to *encourage* the trustees of public employee retirement systems, pension funds, and investment boards to use emerging investment managers in managing their system's assets, encompassing all asset classes, and increase the racial, ethnic, and gender diversity of its fiduciaries, to the *greatest extent feasible* within the bounds of financial and fiduciary prudence, and to take affirmative steps to remove any barriers to the full participation in investment opportunities afforded by those retirement systems, pension funds, and investment boards. . . .
>
> If in *any case* an emerging investment manager meets the criteria established by a board for a specific search and meets the criteria established by a consultant for that search, then that emerging investment manager *shall* receive an invitation by the board of trustees, or an investment committee of the board of trustees, to present his or her firm for *final consideration* of a contract.[118]

Though the language of the first excerpted portion is of encouragement of minority business use rather than that of prescription, encouragement has been recognized by courts to be enough to trigger strict scrutiny.[119] Furthermore, the second excerpted portion of the statute indicates that race and gender will be used as a means of awarding preference. Not every investment manager will be invited by the board to present for final consideration. The fact that minority managers get a fast track to the final interview means that they have been awarded an advantage on the basis of race. This squarely fits within the realm of racial classification as contemplated by *Adarand* and numerous other affirmative action cases. For example, in *Adarand*, the regulation that provided incentives to hire minority contractors did not require it, and did not set a quota.[120] Strict scrutiny thus "applies

117. 40 ILL. COMP. STAT. 5/1-109.1(b)(4) (2014).

118. *Id.* (emphasis added).

119. Lutheran Church-Missouri Synod v. F.C.C., 154 F.3d 487, 492 (D.C. Cir. 1998) ("[I]t is the fact of encouragement . . . that makes this regulation a racial classification."); Monterey Mech. Co. v. Wilson, 125 F.3d 702, 707 (9th Cir. 1997) ("A person suffers injury in fact if the government requires or encourages as a condition of granting him a benefit that he discriminate against others based on their race or sex."); Cleveland Constr., Inc. v. Cincinnati, 169 Ohio App. 3d 627, 641, 2006-Ohio-6452, 864 N.E.2d 116, 126 *rev'd,* 118 Ohio St. 3d 283, 2008-Ohio-2337, 888 N.E.2d 1068 ("When regulations pressure or encourage contractors to hire minority subcontractors, courts must apply strict scrutiny.").

120. Adarand Constructors, Inc. v. Pena, 515 U.S. 200, 262 (1995).

to *all* racial classifications, not just those creating binding racial preferences."[121]

As is with the case with most states that employ diversity manager initiatives, the practical means by which the Illinois pension actually carries out the statute results in a state action that classifies on the basis of race. For example, the Investment Guidelines for Illinois sets out apportionment for utilizing minority managers. For example, Investment Guidelines for Illinois sets out apportionments for minority managers. In 2009 it was 30% for fixed income managers and 10 to 12% for equities managers.[122] These set-aside allocations in themselves are racial classifications subject to constitutional review.

Other PPFs do not have statutory prescriptions, but nevertheless would trigger strict scrutiny because they implement a race-based classification when it puts out a search for a diverse manager. For example, though the state of Pennsylvania does not have a diverse manager statute, when the Philadelphia Board of Pensions and Retirement puts out a search for a diverse manager on its website, and the only funds that could qualify are "minority-, woman-, or disabled-owned firm" with an office in Philadelphia that has an AUM of less than $2 billion.[123] That is a government action that classifies on the basis of race.

There is an open question of whether programs like that of CalPERS and CalSTRS trigger strict scrutiny. Though both funds herald racial and gender diversity as important goals, and though they both keep track of minority and women-owned investment managers in its reports on their emerging manager programs, the statute leaves the Boards of both funds to decide what "emerging manager" means, and they have decided to use only size and age of prospective funds as criteria.[124] If the administration of these funds does not involve state action that draws racial lines of any sort, then these plans probably would not be subject to strict scrutiny, or run afoul of Prop 209. On the other hand, if there is evidence that certain minority funds get preference within the broader race-neutral framework of emerging

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121. Virdi v. DeKalb Cnty. Sch. Dist., 135 F. App'x 262, 267 (11th Cir. 2005) (emphasis in original).

122. Illinois State Board Of Investment, *Illinois State Board of Investment Targeted Investment Policy, Form Request for Competitive Proposal: Investment Consultant*, ILLINOIS.GOV 17 (Dec. 18, 2009).

123. Kevin Olsen, *Philadelphia Pension Board Eyes Emerging Managers for International Equity*, PENSIONS & INV. (Jan. 2, 2014), http://www.pionline.com/article/20140102/ONLINE/140109978/philadelphia-pension-board-eyes-emerging-managers-for-international-equity.

124. Laurie Weir, *CalPERS Emerging Manager and Diverse Manager Forum: CalPERS Five Year Emerging Manager Plan*, CALPERS 4 (Dec. 3, 2012), *available at* https://www.CalPERS.ca.gov/eip-docs/investments/emerging-manager.pdf.

funds, the funds might end up facing strict scrutiny review. For example, if CalPERS and CalSTRS are loathe to fire minority funds because of fear of backlash from various interest groups,[125] that might become suspect.[126] Other programs that are not explicitly wholly race- or gender- based could still trigger strict scrutiny. For example, North Carolina's program has a facial requirement of managers of large-cap U.S. equities that are registered under the '40 Act and have an AUM between $100 million and $2 billion, but adds that "consistent with the Treasurer's fiduciary duty under North Carolina General Statute §147-69.7, each will determine and consider as a collateral factor whether a manager qualifies as a historically underutilized business as defined by N.C.G.S. §143-128.4."[127] Such a "collateral factor" could very well fall under the purview of the Fourteenth Amendment.

### B. *Historical Development of Government Contract Affirmative Action Jurisprudence*

It was not always the case that any state-based racial classification is automatically constitutionally suspect. The formal history of affirmative action programs begins on September 24, 1965, when President Lyndon Johnson issued Executive Order 11246, which required government actors to "take affirmative action" towards hiring minority employees in government projects.[128] Two years later, on October 17, 1967, Order 11246 was amended to include affirmative action on the basis of gender.[129]

Since then, the practice of government-initiated affirmative action programs for minorities has undergone considerable examination by courts. In 1977, the Supreme Court ruled in *Regents of California v. Bakke*[130] that race-based affirmative action programs are subject to strict scrutiny. The Court ultimately held that diversity is a compelling state interest, but that the University of California's quota preferenc-

125. The evidence on this proposition is thin. However, statements at conferences by lobbyists such as this one could be seen as troubling if it appears that the funds acted on these exhortations: "But we draw a very clear distinction. We are not emerging managers, we are diverse and minority managers, and again within that two percent of the CalPERS portfolio, some of our biggest and best firms were not having success re-engaging with CalPERS." Transcript Part 2, *supra* note 79, at 5.

126. Wygant v. Jackson Bd. Educ., 476 U.S. 267, 283-84 (1986) (holding that the firing of nonminority teachers first is unconstitutional).

127. Emerg*ing Managers Program,* N.C. DEPARTMENT OF STATE TREASURER, 2, *available at* https://www.nctreasurer.com/inv/Documents/EmergingManagerProgram.pdf.

128. Exec. Order No. 11,246, 3 C.F.R. 339 (1964-1965).

129. Exec. Order No. 11,246, 3 C.F.R. 339 (1964-1965), *as amended by* Exec. Order No. 11,375, 3 C.F.R. 684 (1966-1970).

130. 438 U.S. 265 (1978).

ing racial minorities violated the Equal Protection Clause of the Fourteenth Amendment because setting quotas for minority admissions was not the least restrictive means for correcting racial disparities.[131] So began a saga of shifting jurisprudence on the topic of racial classification for "benign" intentions.

In the decade and a half that followed *Bakke*, the Court twice upheld government affirmative action programs, though both the cases involved federal programs. A divided Burger Court upheld in *Fullilove v. Klutznik* that a public construction set-aside statute (the Public Works Employment Act of 1977, which allowed over 10% of federal grant money to be used for minority businesses) on the grounds that Congress has "comprehensive remedial power" to carry out the guarantees of the Equal Protection Clause.[132] However, the divided Court without a majority opinion did not determine the level of scrutiny to review these programs. In 1990, the Court in *Metro Broadcasting v. FCC*[133] chose to defer to the powers of Congress in enacting affirmative action, declining to institute a strict-scrutiny standard for a federal program that partly allowed existing broadcasting stations to be sold exclusively to minority firms. The Court opted for an intermediate scrutiny standard, again on the grounds that federal programs should be treated differently from state and local programs.

Even before *Metro Broadcasting* was decided, the Court tightened the framework for assessing government contracting affirmative action programs to strict scrutiny.[134] Importantly, the Court had been applying strict scrutiny to state and local affirmative action programs early on. In 1986, the Court held in *Wygant v. Jackson Board of Education*[135] that though race-based affirmative action in public school hiring decisions is sometimes permissible, the firing of non-minority employees before minority employees of similar characteristics was not permissible if based on history of private discrimination.

In 1989, the Court applied strict scrutiny to government contracting affirmative action programs in *City of Richmond v. J.A. Croson Co.*[136] It held that affirmative action is a "highly suspect tool" and cannot stand when based on "amorphous claim[s]" of past discrimination.[137] The Court in Croson struck down a city ordinance that set aside 30%

131. *Id.* at 289-90.
132. 448 U.S. 448, 483 (1980).
133. 497 U.S. 547 (1990).
134. The *Metro Broadcasting* court had to distinguish the case from the *Croson* holding just a year prior, by drawing a line between federal programs and state and local programs. *Id.* at 565.
135. 476 U.S. 267, 274 (1986).
136. 488 U.S. 469 (1989).
137. *Id.* at 493, 499.

of its public contracts for MBEs on the grounds that the ordinance cannot withstand review under the strict scrutiny analysis that must apply to all race-based laws.[138] *Croson* set forth the requirement that the government actor would need to document evidence of discrimination that would justify the affirmative action.[139] This cannot be general pervasive discrimination. The rationale articulated by Justice O'Connor in *Croson* is that the strict scrutiny standard will "'smoke out' illegitimate uses of race by assuring that the legislative body is pursuing a goal important enough to warrant use of a highly suspect tool."[140] In addition, the program would need to pass the narrow tailoring test as well.

Six years, later the Supreme Court extended the *Croson* holding to federal programs, overturning its holding in *Metro Broadcasting*. In *Adarand Constructors Inc. v. Pena*, the standard of strict scrutiny was further underscored as applicable to well-intentioned race-based federal government action.[141] Because the *Adarand* case was remanded, *Croson* was the "last substantive decision on the requirements of strict scrutiny in affirmative action programs in public contracting" by SCOTUS.[142]

In the aftermath of *Croson* and *Adarand*, the state of government contract affirmative action programs implicating race appeared bleak. Some programs were eliminated, as both legislatures and executives responded to the Court's rulings.[143] The Department of Justice began

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138. *Id.* at 506.

139. *Id.* at 480.

140. *Id.* at 493.

141. 515 U.S. 200, 205 (1995). This came as a surprise to many in the legal community, because the language in *Croson* implied that the Fourteenth Amendment gave special powers to the federal Congress to enforce the Equal Protection Clause. However, the *Adarand* Court demanded "congruence" between state and federal approaches to affirmative action. *Id.* at 224. The question of whether the federal standard should match the state standard was a source of debate surrounding the *Adarand* decision. *See, e.g.*, Paul J. Mishkin, *Foreword: The Making of a Turning Point—Metro and Adarand*, 84 CAL. L. REV. 875, 879 (1996). However, this course of development is largely irrelevant to the issue at hand, because state pensions would have been governed under the *Croson* strict scrutiny standard regardless of how the Court chose to regard the issue of congruency between state and federal standards when considering the *Adarand* case.

142. Lynn Ridgeway Zehrt, *A Decade Later:* Adarand *and* Croson *and the Status of Minority Preferences in Government Contracting*, 21 NAT'L BLACK L.J. 1, 7 (2009)

143. After *Adarand*, President Clinton issued a memorandum that sought to eliminate any program that "(a) creates a quota; (b) creates preferences for unqualified individuals; (c) creates reverse discrimination; or (d) continues even after its equal opportunity purposes have been achieved." Memorandum from President William J. Clinton on Affirmative Action (July 19. 1995), *available at* http://www.presidency.ucsb.edu/ws/?pid=51632. Congress also "considered terminating federal affirmative action programs" and ultimately made changes to statutes that contained minority preferencing, like the SBA, ISTEA, and STURAA. Zehrt, *supra* note 142, at 6. The amendments "impose[d] heavier documentary and other burdens upon states and local governments participating in federal contracting programs." *Id.* at 6.

attempting to amass existing evidence to help federal programs meet the evidentiary hurdles.[144]

Nevertheless, some programs remained and legal challenges ensued. Of the twenty-two government contracting cases brought under the strict scrutiny standard to federal Courts of Appeal and state supreme courts after *Croson*, only seven fully survived strict scrutiny review.[145] Of the federal programs challenged after *Adarand* that reached federal courts of appeal or state supreme courts, five of eight[146] survived strict scrutiny review. Only *two* of the fourteen programs involving state/local programs challenged after *Croson* survived strict scrutiny review in Courts of Appeal or state supreme courts (another was partially upheld, for some racial categories but not for others, and not for gender).[147] Thus, government contracting pro-

144. Proposed Reforms to Affirmative Action in Federal Procurement, 61 Fed. Reg. 26,042-01 (May 23, 1996). A number of lower court cases found the materials in this report persuasive, including the Tenth Circuit when considering the *Adarand* case on remand. Adarand Constructors, Inc. v. Slater (*Adarand VII*), 228 F.3d 1147, 1176 (10th Cir. 2000).

145. *See infra* notes 147 and 148. There are some cases involving federal programs, decided after *Croson* but before *Adarand.* Because the strict scrutiny standard was not clearly applicable to the government programs in this era of cases, they are not included in this analysis. *See, e.g.*, Winter Park Commc'ns, Inc. v. F.C.C., 873 F.2d 347, 354 (D.C. Cir. 1989), *aff'd and remanded sub nom.* Metro Broad., Inc. v. F.C.C., 497 U.S. 547 (1990), *overruled by* Adarand Constructors, Inc. v. Slater, 515 U.S. 200 (1995); Harrison & Burrowes Bridge Constructors, Inc. v. Cuomo, 981 F.2d 50, 57 (2d Cir. 1992); Milwaukee Cnty. Pavers Ass'n v. Fiedler, 922 F.2d 419, 424 (7th Cir. 1991). There are of course also numerous federal district court and lower state court decisions using the *Croson/Adarand* standard. For a partial listing by Professor George La Noue of the University of Maryland Baltimore Cnty., see *Disparity Studies as Evidence of Discrimination in Federal Contracting: Briefing Report,* U.S. COMM'N ON CIVIL RIGHTS 23, 26 n.4 (May 2006), *available at* http://www.usccr.gov/pubs/DisparityStudies5-2006.pdf (collecting cases of times when courts have criticized state and local disparity studies) [hereinafter USCCR Report].

146. The five that were upheld were: Associated Gen. Contractors of Am., San Diego Chapter, Inc. v. Cal. Dep't of Transp., 713 F.3d 1187 (9th Cir. 2013); N. Contracting, Inc. v. Illinois, 473 F.3d 715 (7th Cir. 2007); W. States Paving Co. v. Wash. Dep't of Transp., 407 F.3d 983 (9th Cir. 2005) (upholding the federal program but striking down the state program on an as-applied challenge); Sherbrooke Turf, Inc. v. Minn. Dep't of Transp., 345 F.3d 964 (8th Cir. 2003); Adarand Constructors, Inc. v. Slater, 228 F.3d 1147 (10th Cir. 2000).

The three struck down in the Federal Courts of Appeal were: Rothe Dev. Corp v. Dep't of Def., 545 F.3d 1023 (Fed. Cir. 2008); MD/DC/DE Broadcasters Assoc. v. F.C.C., 236 F.3d 13 (D.C. Cir. 2001); Lutheran Church-Mo. Synod v. F.C.C., 141 F.3d 344 (D.C. Cir. 1998).

In addition, consider Shurberg Broad. of Hartford, Inc. v. F.C.C., 876 F.2d 902, 926 (D.C. Cir. 1989) *rev'd sub nom.* Metro Broad., Inc. v. F.C.C., 497 U.S. 547 (1990) *overruled by* Adarand Constructors, Inc. v. Slater, 515 U.S. 200. *Shurberg* was a post-*Croson* case where the D.C. Circuit found the program unconstitutional by applying a strict scrutiny standard, but was reversed by the Supreme Court in *Metro Broadcasting* in 1990. However, because *Adarand* itself overruled *Metro Broadcasting*, it appears that the program in *Shurberg* does not survive strict scrutiny.

147. The fully upheld state/local programs were: Concrete Works of Colo., Inc. v. City & Cnty. of Denver (*Concrete Works IV*), 321 F.3d 950 (10th Cir. 2003) and Ritchey Produce Co. v. Ohio Dep't of Adm. Serv., 85 Ohio St. 3d 194, 254, 1999-Ohio-262, 707 N.E.2d 871, 914 (1999). The partially-upheld program was in H.B. Rowe Co. v. Tippett, 615 F.3d 233 (4th Cir. 2010). Also, in

grams that involve preferencing minority business – in the way that some PPFs favor diverse managers – may face significant risk of invalidation if challenged in court.[148]

### C. *Strict Scrutiny Post-*Croson *and* Adarand

In this section, I examine the standards for passing strict scrutiny set forth in *Croson* and subsequent cases evaluating local and state programs. The strict scrutiny standard in *Croson*, reaffirmed by *Adarand* for federal government programs, presents difficulties for PPFs from two fronts. First, the Court set a very high bar for the quantity and quality of documentary evidence required to establish compelling state interest.[149] Second, the narrow-tailoring requirement essentially requires that the government tries race-neutral approaches before resorting to affirmative action programs at all. Understanding how courts apply these standards is crucial to evaluating whether PPFs' diverse manager programs are likely to survive a challenge.

#### 1. Strict Scrutiny in Practice According to *Croson*

The Supreme Court has held that the proper standard for reviewing government programs for race-based affirmative action (based on

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Associated Gen. Contractors of California, Inc. v. Coal. for Econ. Equity, 950 F.2d 1401, 1414 (9th Cir. 1991), a challenge to the program was found to not survive preliminary injunction on the reasoning that the plaintiff was not likely to succeed on the merits as the government produced enough evidence of compelling state interest and narrow tailoring. The Court of Appeals affirmed the District Court's finding, and the case did not continue after the denial of preliminary injunction.

The unsuccessful state/local programs challenged in Federal Courts of Appeal were: W. States Paving Co. v. Wash. Dep't of Transp., 407 F.3d 983 (9th Cir. 2005) (including both a facial challenge to federal statute and an as-applied challenge to state program); Builders Ass'n of Greater Chi. v. Cnty. of Cook, 256 F.3d 642 (7th Cir. 2001); Associated Gen. Contrs. of Ohio, Inc. v. Drabik, 214 F.3d 730 (6th Cir. 2000); W H Scott Constr. Co. v. City of Jackson, Miss., 199 F.3d 206 (5th Cir. 1999); Eng'g Contractors Ass'n v. Metro. Dade Cnty., 122 F.3d 895 (11th Cir. 1997); Monterey Mech. Co. v. Wilson, 125 F.3d 702 (9th Cir. 1997); Contractors Ass'n v. City of Phila. (*Contractors Ass'n III*), 91 F.3d 586 (3d Cir. 1996); O'Donnell Const. Co. v. D.C., 963 F.2d 420, 427 (D.C. Cir. 1992); Coral Const. Co. v. King Cnty., 941 F.2d 910, 917 (9th Cir. 1991). The remaining three unsuccessful cases were state supreme court cases: Cleveland Constr., Inc. v. City of Cincinnati, 864 N.E.2d 116 (Ohio Ct. App. 2006); L. Feriozzi Concrete Co. v. Casino Reinvestment Dev. Auth., 776 A.2d 254 (N.J. Super. Ct. App. Div. 2001); La. Ass'n Gen. Contractors, Inc. v. State Div. of Admin., 669 So.2d 1185 (La. 1996).

148. Critics have pointed out that the "lack of constitutional certainty in this area has potentially significant costs" for governments, lower courts, and businesses both nonminority and minority who must operate in the realm of uncertainty. Subash Iyer, *Note: Resolving Constitutional Uncertainty in Affirmative Action Through Constrained Constitutional Experimentation*, 87 N.Y.U. L. REV. 1060, 1063-64 (2012).

149. Accordingly, some Congressional amendments to contracting statutes after *Adarand* also "impose[d] heavier documentary and other burdens upon states and local governments participating in federal contracting programs." Zehrt, *supra* note 142, at 6.

"benign" or "remedial" intentions) is strict scrutiny.[150] The only time the Court has applied this test substantively is in the *Croson* case, but a number of lower courts have applied *Croson* to other cases.[151] I first review the Court's reasoning in *Croson*, and then turn to the few cases in which Courts of Appeals have upheld government contracting affirmative action programs after *Croson*.

In *Croson*, the program set up by the City of Richmond was meant to expand minority firm participation in city public contracting. Like many emerging manager programs, the City of Richmond program was not restricted to contractors in Richmond itself. The city set up a program for Minority Business Enterprise subcontractors to receive at least 30% of the dollar value of city-award contracts.[152] The *Croson* company, a non-minority business, was the only bidder on a project but nevertheless did not win the bid because it did not have MBE subcontractors. After it sued the city, the district court and Court of Appeals both upheld the set-aside plan, but after the Supreme Court remanded the case in light of the *Wygant v. Jackson Board of Education* decision, the Court of Appeals reversed course and struck down the program on remand, partially by reading *Wygant* to mean that the Constitution does not permit public action to remedy private discrimination.[153] The Supreme Court then affirmed the remanded decision but specified that it is permissible in some cases to use public action to remedy private discrimination.[154]

The Court found that the City of Richmond's plan did not pass strict scrutiny test first and foremost because it did not provide sufficient evidentiary basis to show past discrimination in need of rem-

150. City of Richmond v. J. A. Croson Co., 488 U.S. 469, 493; *Adarand III*, 515 U.S. at 205.

151. A number of other state court cases consider similar programs against the requirements of their state constitutions. These cases are typically in states where the state constitutional bar on race- and gender-based categorizations are even stricter than that of the federal Constitution. *See, e.g.*, Hi-Voltage Wire Works, Inc. v. City of San Jose, 12 P.3d 1068, 1072 (Cal. 2000) (holding that a MBE program violated the California constitution); La. Ass'n Gen. Contractors, Inc. v. State Div. of Admin., 669 So.2d 1185, 1202 (La. 1996) (holding that a minority set-aside program violated the Louisiana constitution).

152. *Croson*, 488 U.S. at 477-78. MBEs were defined as businesses at least 51% owned or controlled by "minority group members," which included U.S. citizens who were "Blacks, Spanish-speaking, Orientals, Indians, Eskimos, or Aleuts." *Id.*

153. Wygant v. Jackson Bd. of Educ., 476 U.S. 267, 291 (1986) ("[P]ublic employers are trapped between the competing hazards of liability to minorities if affirmative action is not taken to remedy apparent employment discrimination and liability to nonminorities if affirmative action is taken.").

154. *Croson*, 488 U.S. at 485-86, 490, 492 (plurality opinion). Dissenters Justices Marshall, Brennan and Blackmun also found that remedying private discrimination is a compelling state interest. *Id.* at 538.

edy.[155] In the Court's view, this failed the first prong of compelling state interest. In finding this, the Court rejected the District Court's reliance on five "predicate 'facts'" to find past discrimination: first, that the ordinance was explicitly remedial, second, that there was anecdotal evidence of past discrimination, third, the disparity between the percent of minorities in the general population versus in the contracting world, fourth, that there were few minority contractors in the state professional associations, and fifth, that Congress had previously observed that the construction business is prone to excluding minorities.[156]

In the Supreme Court's view, these were insufficient for two reasons. First, the disparity between the African-American population in Richmond and the African-American population in contractors was not deemed as sufficient evidence of past discrimination. In the Court's view, "a generalized assertion that there has been past discrimination in an entire industry provides no guidance for a legislative body to determine the precise scope of the injury it seeks to remedy."[157] Second, because the problem discussed is so "ill-defined," the Court feared that the remedy would go on far too expansively and for too long.[158] It appears that what *Croson* Court would demand is an extremely specific type of analysis that demonstrates discrimination by showing that the capacity of minority businesses in the area that is qualified to perform the job is higher than those who are actually hired to do it.[159] In the Court's words, "where special qualifications are necessary, the relevant statistical pool for purposes of demonstrating discriminatory exclusion must be the number of minorities qualified to undertake the particular task."[160] The Court's rejection of the City of Richmond's evidence set a standard for later decisions by lower courts, which tended to hold that government affirmative action programs generally failed to pass the test. They "substantiate[d] Justice Marshall's concern that the Court's decision places an 'onerous documentary obligation[n]' upon government entities."[161]

The Court noted that in the absence of specific links to past discrimination, it was "impossible to assess whether the Richmond Plan is narrowly tailored" to remedy such discrimination.[162] However, it

155. *Id.* at 508.
156. *Id.* at 499.
157. *Id.* at 498.
158. *Id.* at 498, 505-06.
159. *Croson*, 488 U.S. at 501-02.
160. *Id.* at 501-02.
161. Zehrt, *supra* note 142, at 9 (citing *Croson*, 488 U.S. at 507).
162. *Croson*, 488 U.S. at 507.

made two "observations" about narrow tailoring in this case before concluding that it would not survive such a test:[163] first, the consideration of race-neutral alternatives,[164] and second, the numerical quota of 30 percent "cannot be said to be narrowly tailored to any goal, except perhaps outright racial balancing[,]"[165] which suggests that there needs to be some sort of proportionality. In addition, elsewhere in the opinion, the Court lamented the potential for "race-based decision-making essentially limitless in scope and duration" as a problem for the Richmond program.[166] This suggests that timing and extent of the program would also factor into a narrow tailoring analysis under *Croson.*

### 2. Subsequent Lower Court Decisions

A number of lower courts following *Croson* have also reviewed government contracting programs. Taken in sum, the *Croson* decision and its progeny yield a complex, multitier analysis for courts to consider when faced with a government sponsored affirmative action program in contracting. Understanding these applications is crucial because one important legacy of *Croson* is that the strict scrutiny standard in practice requires specific documentary evidence, and the evaluation of that evidence is done on a case-by-case basis.[167]

#### a. Lower Court Application of Compelling State Interest

First, there must be a determination of whether there is discrimination by a specific entity, and this must be proven up with evidence prior to the program's beginning. In the Court's words, the state's effort to use affirmative action as a remedial measure need to do at least two things to reach the level of compelling state interest: first, there must be "some specificity" in the identification of discrimination by the private or public entity instead of asserting societal discrimination.[168] As the Sixth Circuit observed in *Associated Gen. Contractors of Ohio, Inc. v. Drabik*:[169]

> Thus, the linchpin of the *Croson* analysis . . . is not simply its mandating of strict scrutiny, the requirement that a program be narrowly tailored to achieve a compelling government interest, but

163. *Id.* "We think it obvious that such a program is not narrowly tailored to remedy the effects of prior discrimination." *Id.* at 508.

164. *Id.* at 507 (citing United States v. Paradise, 480 U.S. 149, 181 (1987).

165. *Id.*

166. *Croson*, 488 U.S. at 498.

167. *See* Appendix C for a matrix listing applicable cases and their holdings.

168. *Id.* at 504.

169. 214 F.3d 730, 735 (6th Cir. 2000).

above all its holding that governments must "identify discrimination with some specificity before they may use race-conscious relief;" explicit "findings of a constitutional or statutory violation must be made."[170]

The specificity requirement is important because generalized declarations of disparity – including declarations by the legislature – are not enough.[171] In addition, the analysis may turn on whether the discrimination is by the government, or by private entities. Rectifying the government's own discrimination is usually deemed as an appropriately compelling state interest. However, if there was private discrimination, the court would then have to review whether the form of private discrimination is of a sort that would allow government remedy.[172]

Second, the government must provide a "strong basis in evidence" that there was discrimination "before it embarks on an affirmative action program" to show that the remedy was necessary.[173] As a formal matter, the government has a burden of producing strong evidence of racial disparity. However, there is no need to definitively prove it up at this point. In *Concrete Works,* the court clarified that, "To meet its initial burden, Denver was not required to unequivocally establish the existence of discrimination nor was it required to 'negate all evidence of non-discrimination.'"[174] In evaluating the "initial burden," courts have taken a varied approach as to the validity of forms, amounts, and recency of evidence.

Successful challenges typically include a battery of statistical studies as well as anecdotal evidence.[175] Most courts of appeal rely on the

170. *Id.* (quoting *Croson*, 488 U.S. at 497).

171. *Croson,* 488 U.S. at 499 (holding that legislative assertions are not enough). *See* Miller v. Johnson, 515 U.S. 900, 923 (1995) (holding that no deference should be given to legislative declarations that result in racial categorization).

172. The Supreme Court has not fleshed out what this would mean in practice.

173. Wygant v. Jackson Bd. Educ., 476 U.S. at 277; *see also* Shaw v. Hunt, 517 U.S. 899, 909-10 (1996).

174. Concrete Works v. City & Cnty. of Denver (*Concrete Works II*), 36 F.3d 1513, 1530 (10th Cir. 1994).

175. *See, e.g.*, Associated Gen. Contractors of Am., San Diego Chapter, Inc. v. California Dep't of Transp., 713 F.3d 1187, 1191-92 (9th Cir. 2013) (presenting disparity study supplemented by anecdotal evidence); Concrete Works of Colo., Inc. v. City and Cnty. of Denver (*Concrete Works IV*), 321 F.3d 950, 960-971 (10th Cir. 2003) (presenting a number of federal reports and another slew of consultant-conducted statistical studies, including disparity studies, as well as anecdotal evidence); N. Contracting, Inc. v. Illinois, 473 F.3d 715, 718-21 (7th Cir. 2007) (presenting consultant studies using a "custom census" instead of disparity studies, and anecdotal evidence from public hearings); Sherbrooke Turf, Inc. v. Minn. Dep't of Transp., 345 F.3d 964 (8th Cir. 2003) (presenting consultant statistical studies, but not disparity study); Adarand Constructors, Inc. v. Slater (*Adarand VII*), 228 F.3d 1147, 1166-69 (10th Cir. 2000)

calculation of a "disparity index."[176] The general rule is that disparity indices lower than 80% participation indicates discrimination may have occurred.[177] However, this is not at all a hard and fast rule. Some courts deem a 22.5 disparity index a "close call" and punted on the question entirely.[178] In addition, a number of courts also consider whether the disparity index calculation is statistically significant.[179]

There is also a debate over the numerator of the disparity index. In other words, it is unclear whether to compare the level of utilization of minority businesses with 1) the percentage of minority businesses in the area, 2) the percentage of minority businesses that have the capacity to fulfill the contract, or 3) the percentage of minority businesses that are qualified, willing, and able to fulfill the contract.[180] From *Croson*, we know that a comparison between the level of minority business utilization versus the population generally is not enough.[181] Sometimes, the second option: of looking at capacity – is enough.[182] However, courts are not consistent, and some may require the third option.

In *Rothe Dev. Corp v. Department of Defense*,[183] for example, the Federal Circuit considered six disparity studies presented with low dis-

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(presenting anecdotal evidence before Congress, disparity studies, and utilization studies showing that when the program ended, minority participation dropped).

176. H.B. Rowe Co. v. Tippett, 615 F.3d 233, 243-44 (4th Cir. 2010); Rothe Dev. Corp. v. Dep't of Def., 545 F.3d 1023, 1037–38 (Fed. Cir. 2008); *Concrete Works IV*, 321 F.3d at 962–63; W H Scott Constr. Co. v. City of Jackson, 199 F.3d 206, 218 (5th Cir. 1999); Eng'g Contractors Ass'n v. Metro. Dade Cnty., 122 F.3d 895, 914 (11th Cir. 1997); Contractors Ass'n v. City of Phila. (*Contractors Ass'n II*), 6 F.3d 990, 1005 (3d Cir. 1993); Associated Gen. Contractors of Cal., Inc. v. Coal. for Econ. Equity, 950 F.2d 1401, 1413–14 (9th Cir. 1991). Others have used similar statistical indices. *See, e.g.*, Associated Gen. Contractors v. Coalition for Economic Equity, 950 F.2d 1401, 1414 (9th Cir. 1991).

177. *H.B. Rowe Co.*, 615 F.3d at 244; *Rothe*, 545 F.3d at 1041; *Eng'g Contractors*, 122 F.3d at 914.

178. Contractors Ass'n v. City of Phila. (*Contractors Ass'n III*), 91 F.3d 586, 605 (3d Cir. 1996).

179. *H.B. Rowe Co*, 615 F.3d at 244; E*ng'g Contractors*, 122 F.3d at 914.

180. Experts disagree on the quality of disparity studies. The U.S. Commission on Civil Rights has prepared a report on the issue, with varying viewpoints from different scholars. *See generally* USCCR Report, supra note 145.

181. *See Croson*, 488 U.S. at 498. *See also* O'Donnell Const. Co. v. D.C., 963 F.2d 420, 426-27 (D.C. Cir. 1992) (noting that disparity figures between city population and percent contracts awarded is "constitutionally meaningless").

182. *See, e.g.*, Concrete Works of Colo., Inc. v. City and Cnty. of Denver (*Concrete Works IV*), 321 F.3d 950 (10th Cir. 2003) (presenting evidence in various forms, including utilization rates that distilled away potential intervening factors, and another study that studied the actual versus potential availability rate *if* minority firm formation rates were equal to whites/males). *See also* N. Contracting, Inc. v. Illinois, 473 F.3d 715 (7th Cir. 2007) (relying on a "custom census" instead of a disparity study); Sherbrooke Turf, Inc. v. Minn. Dep't of Transp., 345 F.3d 964 (8th Cir. 2003) (relying on statistical studies that are not disparity studies).

183. 545 F.3d 1023 (Fed. Cir. 2008).

parity indices, but questioned the benchmark because two of the studies did not consider whether all the businesses available were actually willing and able to fulfill the contract. There, the court did not state whether the "qualified, willing and able" standard should be always used, but found that the totality of questions such as this one made the studies "substantially less probative" though not "wholly unreliable."[184] It ultimately held that there was no compelling state interest, even when taken together with other statistical and anecdotal evidence.[185] Similarly, in *Associated General Contractors of Ohio, Inc. v. Drabik*,[186] the Sixth Circuit found a number of problems with the statistical studies, including the fact that they "make[ ] no attempt to identify minority construction contracting firms that are ready, willing, and able to perform state construction contracts of any particular size."[187]

Because the standards seem to be mercurial from year to year and from court to court, there is a high level of uncertainty as to what it takes to present enough evidence to demonstrate compelling government interest.[188] Below, I list the myriad problems that courts have found with evidence presented to show racial disparity in three of the cases that were found unconstitutional. I match up similar rationales in the same rows, so that each row show a distinct issue raised by the courts.

| *Rothe*[189] | *Drabik*[190] | *W H Scott Construction*[191] |
|---|---|---|
| The six disparity studies did not account for the size of the businesses, only accounted for contract size. | Evidence cannot account for the question of what happens if firms split and suddenly there are more firms in the numerator without any substantive exacerbation of problems | |

184. *Rothe*, 545 F.3d at 1044-45.

185. *Id.* at 1049. The Federal Circuit in *Rothe* appeared nervous to set a too-high standard. It noted that its "holding is grounded in the particular items of evidence offered by DOD and relied on by the district court . . . should not be construed as stating blanket rules." *Id.*

186. 214 F.3d 730, 835 (6th Cir. 2000).

187. *Id.* at 736-37.

188. *See* Iyer, *supra* note 149, at 1063-64; USCCR Report, *supra* note 145, at 63-69.

189. *Rothe*, 545 F.3d at 1047-50.

190. Associated Gen. Contractors of Ohio, Inc. v. Drabik, 214 F.3d 730, 736-38 (6th Cir. 2000).

191. W H Constr. Co. v. City of Jackson, Miss., 199 F.3d 206 (5th Cir. 1999).

| | | |
|---|---|---|
| Some of the disparity studies did not include the benchmark of firms that were qualified, willing, and able to perform the contract | The state "makes no attempt to identify minority construction contracting firms that are ready, willing, and able to perform state construction contracts of any particular size" | |
| | The data's scope did not match up and apply to the specific contracts being considered in the case. | The population considered did not match up and apply to the kinds of contracts being considered in the case (contractors vs. subcontractors) |
| It was unclear how much of the evidence was actually "before Congress" versus merely available | | City did not adopt the findings of the study *before* the law was passed |
| These specific studies (scattered throughout the nation) may not be enough to show *nationwide* discrimination for a federal statute | | |
| | Disparity studies can be defective because they "do not report the actual use of minority firms; they only report the use of minority firms who have gone to the trouble of being certified and listed among the state's 1,180 MBEs . . . ." | |

As this simple grid analysis shows, even states that presented disparity studies were slammed with a litany of challenges (six separate challenges across three cases). Though each challenge is not necessarily dispositive in any given case, this presents a glimpse into what defending government programs might expect. The U.S. Commission on Civil Rights Report on affirmative action in government contracting identified a number of "common flaws" in disparity studies:

> They fail to measure availability according to requirements to compare qualified, willing, and able businesses that perform similar services. They use simple counts of businesses without taking capacity into account. The researchers (1) use obsolete or incomplete data; (2) report results in ways that exaggerate disparities; (3) fail to test

> for nondiscriminatory explanations for the differences; (4) find purported discrimination without identifying instances of bias or general sources; (5) rely on anecdotal information that they have not collected scientifically or verified; (6) do not examine disparities by industry; and (7) neglect to identify which racial and ethnic groups suffer from the disparities.[192]

To build an evidentiary bulwark that can withstand such contestations is arduous. The Commission recommended a number of measures for government entities to take before creating race-conscious programs, including: discarding data over five years old; adhering to "generally accepted standards of social science;" properly benchmarking the "available" pool; using multiple statistical measures of disparity; differentiating between different categories of industries, minority groups, and locales; accounting for capacity issues; performing careful sorting of the numerator and denominator in calculating disparity indices; among others.[193] While not all of these are necessarily required for a government entity to prevail in court, the problem is that failure on any of these fronts could lead to invalidation of the program.

Even if the state presents evidence that appears to establish statistical disparity, the struggle for evidentiary basis for compelling state interest does not end there. After the state or locality has met its burden of providing strong evidence of disparity, the challenging party can introduce rebuttal evidence, at least in the several circuit courts that have applied the *Croson* standard. The rebuttal evidence could be fatal if it can provide particularized evidence "(1) showing that the statistics are flawed; (2) demonstrating that the disparities shown by the statistics are not significant or actionable; or (3) presenting contrasting statistical data."[194]

#### b. Lower Court Applications of Narrow Tailoring Test

Should compelling state interest be established, then the inquiry turns finally to the mode of intervention by the government. A number of state and local programs were invalidated on the grounds that they were not narrowly tailored because they did not consider race-neutral alternatives before turning to racial classification measures.[195] Some courts use the narrow tailoring question as a faster route to fail

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192. USCCR Report, *supra* note 145, at 76.

193. *Id.* at 76-78.

194. Concrete Works of Colo., Inc. v. City & Cnty. of Denver (*Concrete Works IV*), 321 F.3d 950, 959 (10th Cir. 2003). *See also* Adarand Constructors, Inc. v. Slater (*Adarand VII*), 228 F.3d 1147, 1175 (10th Cir. 2000); Coral Constr. Co. v. King Cnty., 941 F.2d 910, 921 (9th Cir.1991); Eng'g Contractors Ass'n v. Metro. Dade Cnty., 122 F.3d 895, 916 (11th Cir.1997); Contractors Ass'n v. City of Phila. (*Contractors Ass'n II*), 6 F.3d 990, 1007 (3d Cir.1993).

195. *See* Zehrt, *supra* note 143, at 24 (collecting cases).

the government program on strict scrutiny, and thus sometimes bypass the compelling state interest prong entirely.[196]

The Supreme Court has made it clear that "narrow tailoring does not require exhaustion of every conceivable race-neutral alternative."[197] However it does "require serious, good faith consideration of workable race-neutral alternatives."[198] As we know, *Croson* considered the consideration of race-neutral alternatives, proportionality of numerical targets, and possibly duration of program.[199] But because the Richmond program did not demonstrate prior discrimination, the Court found it difficult to make a narrow tailoring assessment based on remedial goals. In practice, lower courts have adopted an array of factors to test the narrow tailoring requirement, inclusive of the *Croson* court's considerations. As the Fourth Circuit explained in *H.B. Rowe*, the factors to consider include:[200]

> 1) the necessity of the policy and the efficacy of alternative race neutral policies; (2) the planned duration of the policy; (3) the relationship between the numerical goal and the percentage of minority group members in the relevant population; (4) the flexibility of the policy, including the provision of waivers if the goal cannot be met; and (5) the burden of the policy on innocent third parties ... [and] a program's "overinclusiveness," ... *i.e.*, "its tendency to benefit particular minority groups that have not been shown to have suffered invidious discrimination"[201]

An examination of post-*Croson* cases shows that courts have applied permutations of these factors. Many of these cases resulted in invalidations based on narrow tailoring.[202] However, some government

196. *See, e.g.*, Virdi v. DeKalb Cnty. Sch. Dist., 135 F. App'x 262, 268 (11th Cir. 2005); MD/DC/DE Broadcasters Assoc. v. Federal Communications Comm'n, 236 F.3d 13 (D.C. Cir. 2001); Contractors Ass'n v. City of Phila. (*Contractors Ass'n III*), 91 F.3d 586 (3d Cir. 1996).

197. Grutter v. Bollinger, 539 U.S. 306, 339 (2003).

198. *Id.* (citing City of Richmond v. J. A. Croson Co., 488 U.S. 469, 507 (1989) (emphasizing the City of Richmond's failure to consider race-neutral alternatives)).

199. *Croson*, 488 U.S. at 498, 507-08.

200. H.B. Rowe Co. v. Tippett, 615 F.3d 233, 252 (4th Cir. 2010).

201. *Id.* (internal citations omitted).

202. Virdi v. DeKalb Cnty. Sch. Dist., 135 F. App'x 262, 268 (11th Cir. 2005); W. States Paving Co. v. Wash. Dep't of Transp., 407 F.3d 983, 990 (9th Cir. 2005) (finding no narrow tailoring on the state level); MD/DC/DE Broadcasters Assoc. v. F.C.C., 236 F.3d 13, 21-22 (D.C. Cir. 2001); Builders Ass'n of Greater Chi. v. Cnty. of Cook, 256 F.3d 642, 646 (7th Cir. 2001); Assoc. Gen. Contactors of Ohio, Inc. v. Drabik, 214 F.3d 730, 734-35 (6th Cir. 2000); Lutheran Church-Mo. Synod v. F.C.C., 141 F.3d 344, 356 (D.C. Cir. 1998); Eng'g Contractors v. Metro. Dade Cnty, 122 F.3d 895, 906 (11th Cir. 1997); Monterey Mech. Co. v. Wilson, 125 F.3d 702, 714 (9th Cir. 1997); Contractors Ass'n v. City of Phila. (*Contractors Ass'n III*), 91 F.3d 586, 596 (3rd Cir. 1996); O'Donnell Const. Co. v. D.C., 963 F.2d 420, 424 (D.C. Cir. 1992); Coral Const. Co. v. King Cnty., 941 F.2d 910, 925 (9th Cir. 1991); L. Feriozzi Concrete Co., Inc. v. Casino Reinv. Dev. Auth., 776 A.2d 254, 262 (N.J. Super. Ct. App. Div. 2001); Am. Subcontractors Ass'n v. City of Atlanta, 376 S.E.2d 662, 666 (Ga. 1989).

programs reviewed were designed – potentially with strict scrutiny in mind – to pass the test and have done so successfully. For example, though *Croson* noted that the narrow tailoring test would require governments to use "race neutral means" where possible, and only if it is unavailing, to resort to racial classification programs.[203] The Court later stated in *Grutter* that a state need not "exhaust[ ] . . . every conceivable race-neutral alternative."[204] Thus, government affirmative action programs that made good-faith efforts to "consider[ ] an increasing number of race-neutral alternatives" have managed to succeed on that prong of strict scrutiny.[205] On the other hand, programs that did not consider race-neutral means were almost invariably struck down.[206]

Another frequently-invoked question of narrow-tailoring, considered also by *Croson*, is whether there is any end in sight to the program.[207] Some federal programs have survived this test because they require reauthorization.[208] Other programs lacking a sunset provision have not.[209]

The third challenge, about the match between the target goal of the program versus the predicate findings in evidence, can be invoked in a number of ways. Some courts have found that where the program

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203. *Croson*, 488 U.S. at 506-07.

204. Grutter v. Bollinger, 539 U.S. 306, 339 (2003).

205. Assoc. Gen. Contractors of Am. v. Cal. Dep't of Transp., 713 F.3d 1187, 1199 (9th Cir. 2013) (suggesting, however, that it is possible that the state government need not adopt race-neutral alternatives before pursuing racial categorization if the federal government has done so already). *See also H.B. Rowe*, 615 F.3d at 252 (finding that the state had adopted "every conceivable" race-neutral measure); N. Contracting, Inc. v. Illinois, 473 F.3d 715, 724 (7th Cir. 2007) (noting that the government had maximized its goal through race-neutral means); Sherbrooke Turf, Inc. v. Minn. Dep't of Transp., 345 F.3d 964, 972 (8th Cir. 2003) (finding persuasive that the Department of Transportation regulations place great emphasis on race-neutral alternatives); Adarand Constructors, Inc. v. Slater (*Adarand VII*), 228 F.3d 1147, 1178 (10th Cir. 2000) (acknowledging that Congress had considered a number of race-neutral measures over the years).

206. *See Virdi*, 135 F. App'x at 267; *Drabik*, 214 F.3d at 737; Eng'g Contractors Ass'n, 122 F.3d at 928-29; *Contractors Ass'n III*, 91 F.3d 595-96; Shurberg Broad. of Hartford, Inc. v. F.C.C., 876 F.2d 902, 926 (D.C. Cir. 1989) *rev'd sub nom.* Metro Broad., Inc. v. F.C.C., 497 U.S. 547, 622 (1990) *overruled by* Adarand Constructors, Inc. v. Pena, 515 U.S. 200, 237 (1995). Some efforts to adopt race-neutral alternatives were nevertheless deemed not sufficient to pass narrow tailoring. *See* Coral Const. Co. v. King Cnty., 941 F.2d 910, 917 (9th Cir. 1991) (noting that the government did adopt some race neutral alts, like training sessions, info on access, etc., but program was geographically inconsistent with disparity evidence).

207. *See also Grutter,* 539 U.S. at 342.

208. *See H.B. Rowe*, 615 F.3d at 253 (noting that program requires new study every five years); *Adarand VII*, 228 F.3d at 1180 (noting the reauthorization provision).

209. *See, e.g., Virdi*, 135 F. App'x at 268 (rejecting program based on lack of limitations on time); *Drabik*, 214 F.3d at737-38 (noting lack of sunset provision, which had been considered but rejected by legislature); O'Donnell Const. Co. v. D.C., 963 F.2d 420, 428 (D.C. Cir. 1992) (noting lack of timing restrictions on program).

contracts with minority businesses of a different geographic area than what was considered in the study, or did not consider geography at all, the program fails narrow tailoring.[210] Other focused on scenarios in which there was not a direct relationship between the set-aside or target amount versus the degree of disparity for the specific minority group.[211] Thus, cases where the state can show a proportionality relationship between the numerical goal and the numerical disparity findings could succeed.[212]

Fourth, courts favor programs that do not set quotas.[213] In fact, they particularly prefer programs that allow contractors that do not meet the racial criteria to waive into the allotments through good-faith demonstrations.[214]

The last consideration is a combined concern about over-and under-inclusiveness. In this type of inquiry, courts are worried about minority groups who have *not* suffered past discrimination to be included in the list of those who would be favored by the program,[215] as well as by situations where there is a group that is unfairly disadvantaged as a result of the program.[216] A good example where both concerns coexist in the same case is *Associated General Construction of Ohio, Inc. v. Drabik*, where the court noted that the program

> suffers from defects both of over and underinclusiveness. By lumping together the groups of Blacks, Native Americans, Hispanics, and Orientals (and leaving unclear the exact extent of the last two designations), the MBEA may well provide preference where there has been no discrimination, and may not provide relief to groups where discrimination might have been proven.[217]

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210. *See, e.g., O'Donnell*, 963 F.2d at 427; *Coral Const.*, 941 F.2d at 925.

211. *Contractors Ass'n III*, 91 F.3d at 607 (noting that the set-aside amount was not related to the disparity and the goal appeared "arbitrarily chosen").

212. *See H.B. Rowe*, 615 F.3d at 239 (finding particularly persuasive the fact that each committee linked the goal for a project to availability statistics for that project); *Adarand VII*, 228 F.3d at 1182.

213. *See* Sherbrooke Turf, Inc. v. Minn. Dep't of Transp., 345 F.3d 964, 972 (8th Cir. 2003) (addressing lack of quotas favorably); *Adarand VII*, 228 F.3d at 1180 (considering flexibility favorably).

214. *See H.B. Rowe*, 615 F.3d at 253 (noting favorably for the narrow tailoring analysis that nonminorities could make good-faith waivers); W. States Paving Co. v. Wash. Dep't of Transp., 407 F.3d 983, 994-95 (9th Cir. 2005) (upholding the federal program partly because it is flexible, can have shifting goals, and can allow nonminorities with economic disadvantages to qualify).

215. *See* Builders Ass'n of Greater Chi. v. Cnty. of Cook, 256 F.3d 642, 647 (7th Cir. 2001) (rejecting a "laundry list" of minority groups that did not necessarily match up with disparities in contracting).

216. *See* Virdi v. DeKalb Cnty. Sch. Dist., 135 F. App'x 262, 267 (11th Cir. 2005) (striking down a program involving a 15% set-aside for blacks but a 5% set-aside for other minorities).

217. Associated Gen. Contrs. of Ohio, Inc. v. Drabik, 214 F.3d 730, 737 (6th Cir. 2000).

Surviving narrow tailoring is difficult. As Lynne Ridgeway Zehrt reflects, post-*Croson* decisions send the "inherent message . . . that race-based affirmative action programs should only be considered as a last resort and, when used, should be applied to as few minority groups as possible."[218] As demonstrated above, there are certainly ways to pass narrow tailoring, but because there are a number of considerations, programs must address all of the features that may be considered by the court to ensure that they can escape from this strap of the "strict scrutiny straitjacket."[219]

### D. *Gender-Based Classifications and Intermediate Scrutiny*

Although most cases in the affirmative action arena have involved race-based classifications, at least some parts of PPF diverse manager programs pertain to gender and other nonracial classifications. The Supreme Court has never directly reviewed a gender-based affirmative action program. In *Croson*, Justice O'Connor explicitly stated that strict scrutiny's benefits as a tool for reviewing legislative purposes applies to both race and gender.[220] However, subsequent cases on gender discrimination have suggested that the prevailing standard is intermediate scrutiny. In a different context, the Supreme Court has held that gender-based categorizations must establish "exceedingly persuasive justification" and "serve[ ] important governmental objectives."[221] But since the Court has never opined on whether the intermediate scrutiny standard applies to "benign" gender-based affirmative action programs, or only to invidious gender discrimination,[222] it has thus not instructed whether an intermediate scrutiny approach would look quite different from a strict scrutiny standard.

218. *See* Zehrt, *supra* note 143, at 25. The Court's narrow tailoring requirements – specifically that of first attempting race-neutral means – has come under scrutiny by legal critics. Ian Ayres argues that this method actually is not the most narrowly-tailored approach because "[e]xtending affirmative action subsidies to non-victim whites produces less-tailored, overinclusive programs." Ian Ayres, *Symposium on Affirmative Action: Narrow Tailoring*, 43 UCLA L. REV. 1781, 1783 (1996). This is certainly true in the context of emerging managers, which preferences smaller and newer strategies that may include some minorities but also includes whites. These programs might not otherwise be preferred if they did not include the racial composition. But, by including nonminorities in its preferencing scheme, these programs throw into disarray the scope of remedy. Ayres argues that quasi quotas – schemes where the percentage of minority participation would not be allowed to fall below a point where it would seriously negatively affect the viability of minority businesses in general. *Id.* at 1785.

219. City of Richmond v. J. A. Croson Co., 488 U.S. 469, 554 (1989) (Marshall, J., dissenting).

220. *Id.* at 495. *See also* Wygant v. Jackson Bd. Educ., 476 U.S. 267, 286; Assoc. Gen. Contractors of Cal., Inc. v. S.F., 813 F.2d 922, 928 (9th Cir. 1987).

221. United States v. Virginia, 518 U.S. 515, 524 (1996).

222. *See* Concrete Works of Colo., Inc. v. City & Cnty. of Denver (*Concrete Works IV*), 321 F.3d 950, 959 (10th Cir. 2003) ("Neither this court nor the Supreme Court has developed a

This results in a lack of criteria for determining whether a gender-based affirmative action program serves a compelling state interest, or to what extent such a program needs to be narrowly tailored. Thus, lower courts must "work without an analogous evidentiary label from the Supreme Court."[223] Courts of Appeal reviewing gender-based affirmative action programs generally proclaim "something less than the 'strong basis in evidence' required to bear the weight of a race- or ethnicity-conscious program."[224] The definition of "something less" seems to definitely preclude "stereotypical generalizations"[225] and "traditional, often inaccurate, assumptions."[226] Some of these courts struck down gender-based measures when there was no specific evidence of disadvantage,[227] but it is unclear what level of evidence would be enough. Some lower courts have interpreted intermediate scrutiny to mean that the government can use more generalized evidence of societal discrimination,[228] or that the government itself needs not to have been involved actively or passively in the discrimination.[229] It is thus possible that a diverse manager program could fail constitutional review on the race-based hiring portions, but not the gender-based hiring portion of the program.

In the following Part, which focuses on race-based classifications and whether PPFs would survive such review. I do not analyze whether these programs' gender-based classifications would survive intermediate scrutiny, for two reasons. First, as explained above, it is unclear even to Courts of Appeal what exactly intermediate scrutiny entails in the government contracting affirmative action world. Some courts have cautioned that "the difference between the applicable

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framework for analyzing equal protection challenges to gender-based remedial measures."); Eng'g Contractors Ass'n v. Metro. Dade Cnty., 122 F.3d at 909 ("The Supreme Court has not addressed the question explicitly, and there is a similar dearth of guidance in the reported decisions of other federal appellate courts.").

223. *Eng'g Contractors*, 122 F.3d at 909.

224. H.B. Rowe Co. v. Tippett, 615 F.3d 233, 242 (4th Cir. 2010) (quoting *Eng'g Contractors*, 122 F.3d at 909); *see also Concrete Works IV*, 321 F.3d at 959–60; Contractors Ass'n v. City of Phila. (*Contractors Ass'n II*), 6 F.3d at 1010; Coral Const. Co. v. King Cnty., 941 F.2d 910, 931–32 (9th Cir. 1991).

225. *Eng'g Contractors*, 122 F.3d at 910.

226. *Concrete Works IV*, 321 F.3d at 959 (quoting Miss. Univ. for Women v. Hogan, 458 U.S. 718, 726 (1982)).

227. *H.B. Rowe*, 615 F.3d at 256; Mich. Rd. Builders Ass'n v. Milliken, 834 F.2d 583, 595 (6th Cir.1987).

228. Ensley Branch, NAACP v. Seibels, 31 F.3d 1548, 1580 (11th Cir.1994).

229. Coral Const. Co. v. King Cnty., 941 F.2d 910, 932 (9th Cir. 1991) ("Unlike the strict standard of review applied to race-conscious programs, intermediate scrutiny does not require any showing of governmental involvement, active or passive, in the discrimination it seeks to remedy.").

standards has become vanishingly small."[230] This suggests that Courts may not find a functional difference in the standard for evaluating in race- and gender-based remediation government contracting.[231]

Second, even if there is to be a differentiated standard, speculating on that standard is unlikely to be a good strategy for PPFs. Simply guessing what intermediate scrutiny requires in terms of evidence and programmatic tailoring is likely to yield faulty results. Facing an uncertain terrain about the legal standard in other circuits and in the Supreme Court, it may behoove governmental entities to be ready to combat a strict-scrutiny review of gender-based affirmative action programs. This is because there is no case law on what threshold of utilization disparity applies to gender versus race. In one case, the court rejected the gender-based classification even though it applied intermediate scrutiny, because the evidence showed that there was no utilization disparity on the downside for nonminority women.[232] However, that analysis does not set a threshold for how much of a negative disparity is *enough*, and also ignores the fact that it is possible that gender-based utilization disparities exist for *minority* women. In any case, in two of the decisions where the state program survived constitutional review, the court held that the gender-based classification satisfied strict scrutiny and bypassed intermediate scrutiny analysis altogether.[233]

Given the uncertainty around the line between statistical robustness that satisfies strict scrutiny and intermediate scrutiny, it is safest for governmental entities to err on the side of more evidence and narrower tailoring even for gender-based classifications.

## V. APPLYING STRICT SCRUTINY TO PPF DIVERSE MANAGER PROGRAMS

In this Section, I apply the strict scrutiny standard explicated in *Croson*, *Adarand*, and subsequent lower cases to PPFs' diverse man-

230. Builders Ass'n of Greater Chicago v. Cnty. of Cook, 256 F.3d 642, 644 (7th Cir. 2001).

231. This is the approach taken in *Builders Ass'n*. *Id.* at 644-45 (noting that "it is difficult to see what sense [it] . . . makes" to "provide stronger remedies for sex discrimination than for race discrimination"). Because the government in *Builders Ass'n* did not argue for differentiated standards, the court evaluated both programs with strict scrutiny. *Id.* at 644.

232. *H.B. Rowe*, 615 F.3d at 257.

233. *See* Assoc. Gen. Contractors of Am. v. Cal. Dep't of Transp., 713 F.3d 1187, 1195 (9th Cir. 2013) (finding that gender-based classifications are to be measured under intermediate scrutiny, though not defining the evidentiary standard, and holding that the program's gender classification survived strict scrutiny); Concrete Works of Colo., Inc. v. City & Cnty. of Denver (*Concrete Works IV*), 321 F.3d 950, 959 (10th Cir. 2003) (deferring on whether intermediate scrutiny question is appropriate instead finding that the gender classification met the strict scrutiny standard already).

ager programs. I have already demonstrated that at least some diverse manager programs trigger strict scrutiny by taking race-conscious state action. Next, I review the rationales that underlie the PPF diversity manager programs, and conclude that only one – the justice-based reason – could fit under the strict scrutiny doctrine. Finally, I argue that PPFs will have a difficult time surviving both the compelling state interest and the narrow tailoring prongs of the strict scrutiny test. As I make this argument, I will identify specific hurdles that would have to be overcome in order for such programs to survive constitutional review.[234]

### A. *Potential Rationales for Compelling State Interest in Selecting Diverse Managers*

As we have discussed in Part IV, PPFs may have a number of rationales for enacting diversity manager programs, including 1) a belief that diverse managers might bring some additional "plus factors" to the table for investment purposes, 2) a belief that past under-representation problems need to be corrected, and 3) a response to political pressures to increase representation. The last factor is almost certainly unlikely to build a positive case for compelling state interest. This is because courts are unlikely to look at political pressures as in itself a legitimate "legislative . . . goal."[235] Thus, we explore in depth the first two options as possible justifications for race-based action.

The first rationale – the idea that minority managers could be objectively "better" at managing than other managers – is a concept that courts have not opined on. However, this is unlikely to succeed in a defense against strict scrutiny review, on two grounds. First, there is simply not enough supporting empirical evidence to demonstrate that women and racial minorities are better asset managers than their white and male counterparts. As the analysis in Part IV demonstrates, there are no studies to separate out race or gender as the factor that drives performance, and especially not across all asset classes.[236] Though there are some indications that minority managers tend to be newer and smaller, and that these newer and smaller asset managers may perform better, even that tendency-based characterization is not necessarily borne out by empirical evidence.[237]

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234. Though there have been no court challenges on Equal Protection Clause grounds to these programs, the possibility is not foreclosed to future plaintiffs.

235. City of Richmond v. J.A. Croson Co., 488 U.S. 469, 493 (1989).

236. The diverse manager programs typically run across assets and strategies.

237. *Emerging & Diverse Manager Data Report*, *supra* note 76, at 19-24.

Second and perhaps more fatally, the argument for better performance by minority managers would almost certainly fail the narrow tailoring test. In fact, advancing this rationale may drive courts to move directly to narrow tailoring and find that there is no basis for race-conscious action when a performance-based criterion will do. Because the argument rests on the ability of the subgroup of minority managers to deliver objectively better performance than their non-minority counterparts, PPFs will have a hard time demonstrating why they would not use race- and gender-neutral criteria to find better performers before resorting to race- and sex-based sorting criteria.

The "better managers" argument might take an alternate form if there is temptation to try to analogize the contributions of minority managers as similar to the diverse "contributions" of minority students in the educational diversity cases. After all, a major criticism of the asset management business is that many of the firm owners came from the same social networks and business schools, which makes them susceptible to the more pernicious effects of homogeneity. Thus, the reasoning could be that collecting more diverse sources of asset management talent constitutes a compelling state interest. In other words, the advantage of these minority firms would not be that they are better at managing money, but rather that their diversity characteristics make them more attractive to a portfolio.

However, advancing this line of argument would involve fleshing out what that diversity contribution means. In the education context, the Court has focused on how educational diversity creates contributions to the learning process and points of view in the classroom; in other words, there the Court has recognized – to a limited extent – an institutional benefit of different voices.[238] Other options such as "widespread societal discrimination" or "role models" have been rejected.[239] The Court has also not paid much attention to the "service to underserved communities" argument.[240]

The diversity of voices concept, however, does not translate easily to the asset management business. First, the idea that diverse voices can come together to learn from each other is not really plausible in the investment management business. Managers do not ordinarily

238. Other potential benefits include preventing racial isolation and preparing individuals to participate in diverse workplace settings. *See, e.g.*, Meera E. Deo, *Empirically-Derived Compelling State Interests in Affirmative Action Jurisprudence*, 65 HASTINGS L.J. 661, 665 (arguing that courts should consider avoiding racial isolation as a compelling state interest in addition to or in lieu of educational diversity).

239. *Id.* at 668 n.40 (citing Wygant v. Jackson Bd. of Educ., 476 U.S. 267 (1986); Grutter v. Bollinger, 539 U.S. 306 (2003).

240. *Id.* at 8 n.34 (citing Regents of Univ. of Cal. v. Bakke, 438 U.S. 265, 373 (1978)).

meet face-to-face to discuss strategies with each other, especially because many try to keep their investment strategies secret. Even if they did, it would be at industry conferences, not necessarily led by the pension. In any case, such a diversity-of-substance idea is likely to be rejected by courts. The Court had once suggested that diversity could be a compelling state interest in the FCC's distribution of broadcast licenses in *Metro Broadcasting*.[241] However, *Metro Broadcasting*'s holding on this front has been called into question by *Parents Involved*,[242] which suggested that perhaps the diversity interest expressed in *Grutter* only applies to higher education – and thus not to primary schools, or to any other context such as broadcast licenses or investment management. In addition, even *Metro Broadcasting* is inapposite to the instant scenario, because in the broadcasting business it is at least possible to see how diversity of broadcaster can play into the public's receipt of diverse viewpoints. This argument does not work for investment managers, who do not share their strategies broadly, and whose racial identities are unlikely to be substantially relevant to their investment strategy.

Second, a more creative analogy could be that investment firms run by minorities might be more likely to create uncorrelated, "diverse" return streams, which would enhance the diversity of the *portfolio* and lead to better returns. This theory runs into the same problems as the "better performance" line of reasoning: first, it is empirically unproven, and second, even if it were true, it would fail narrow tailoring because PPFs could capture these uncorrelated return streams by targeting diversification in strategy, instead of using race or gender as a proxy.

The other remaining rationale for PPFs' diversity initiatives is that these pensions are fundamentally concerned about equality. As I have explained in Part II.B, there are two logics by which this rationale can operate. One is a desire to reflect the diversity in the demographic of people the institution seeks to serve or support, in this case, the pension population. However, the Court has never advanced this matching-reflectiveness idea as a compelling government interest. Its holding in cases like *Fisher*,[243] *Parents Involved*,[244] and *Grutter*[245] strongly suggest that such a rationale would be summarily dismissed.

241. Metro Broad. v. F.C.C., 497 U.S. 547, 566 (1990).

242. Michelle Adams, *Stifling the Potential of* Grutter v. Bollinger*:* Parents Involved in Community Schools v. Seattle School District No. 1, 88 B.U. L. REV. 937, 979–82 (2008).

243. Fisher v. Univ. of Tex., 133 S. Ct. 2411, 2418 (2013).

244. Parents Involved in Cmty. Sch. v. Seattle Sch. Dist. No. 1, 551 U.S. 701, 727 (2007).

245. Grutter v. Bollinger, 539 U.S. 306, 339 (2003).

The other potential impetus for PPFs to hire minority managers is a desire to rectify past underrepresentation. This concept is far more analogous to the issues at play in *Croson* and other efforts to include more minority-owned businesses in government contracting in a remedial sense.

### B. *The Evidentiary Problem with Remedying Past Discrimination as Compelling State Interest in the Investment Management Industry*

If PFFs use race-based categorizations to rectify past underrepresentation, they face the same evidence issue as the *Croson.* The City of Richmond characterized its program as "remedial," meant to address the issue of low levels of participation by minorities in public construction projects; PPFs would draw from a similar rationale with respect to low participation by minority asset managers. PPFs are unlikely to meet the evidentiary burden for compelling state interest when it comes to historical discrimination against minority asset managers. Like in *Croson*, though the fact that there are so few minority businesses getting hired by the government, this is simply not enough in the face of the law.

Our previous analysis has already revealed that race-conscious remedial government contracting programs are likely to fail, especially those created by state governments.[246] There are only two examples of a state program successfully establishing evidentiary basis for compelling state interest under *Croson.*[247] Only one was in federal court. That case, *Concrete Works of Colorado, Inc. v. City and County of Denver*, involved setting numerical goals for women and minority construction and design contracting.[248] There, in contrast to the City of Richmond in *Croson* and likely in contrast to most other programs, the City of Denver prepared vast amounts of evidence, including: grievance reports alleging discrimination, federal agency reviews reporting discrimination, public hearing testimony to the same effect, and four different studies documenting statistical disparity. In the Tenth Circuit's opinion, this amounted to "extensive evidence [that] support[ed] . . . [that the] ordinance[s] were necessary to remediate

246. Panelists before the U.S. Commission on Human Rights suggest that this is because the quality of disparity studies on the state level is poor. *See* USCCR Report, *supra* note 145, at 17.

247. *See* Zehrt, *supra* note 143, at 19.

248. 321 F.3d 950 (10th Cir. 2003).

discrimination[.]"[249] The other case, *Ritchey Produce Co., Inc. v. Ohio Dep't of Adm. Serv.*,[250] involved the General Assembly of Ohio reviewing statistical data of disparity between qualified MBEs in the state and the number of contracts awarded.

PPFs adopting diverse manager programs do not present a strong basis in evidence to show statistical racial disparities in the public institutional asset management business before the programs were adopted. Programs without statistical studies and other documentary evidence have uniformly been rejected.[251] But so did programs that had varying amounts of disparity evidence that were rejected. As discussed in Part IV.C, there are number of steps that government entities would have to take to successfully defend its race-conscious programs from challenge.[252]

For example, the Federal Circuit was not satisfied with numerous documentary evidence set forth by the Department of Defense in *Rothe*,[253] including six disparity studies that technically met the *Croson* requirement of comparing "qualified" businesses available versus those hired.[254] In *Drabnik*, an Ohio program that set aside 5 percent of its contracting program to minorities was struck down by the Sixth Circuit despite also having availability figures pursuant to disparity studies and other evidence.[255] Thus, the fight to show adequate evidence is a tough one, and as PPF minority manager programs stand today, they are unlikely to win if challenged. Of the potential challenges outlined in Part IV.B.2, PPFs are unlikely to survive any, even if it started anew (i.e., attempted to perform disparity studies and

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249. *Concrete Works IV*, 321 F.3d at 990. In addition, the city attempted a volunteer program encouraging participation in the past, which failed to gain traction, which likely contributed to the Court's finding that the City's plan was narrowly tailored.

250. Ritchey Produce Co. v. Ohio Dep't of Adm. Serv., 85 Ohio St. 3d 194, 254, 1999-Ohio-262, 707 N.E.2d 871, 914 (1999).

251. *See, e.g.*, W. States Paving Co. v. Wash. Dep't of Transp., 407 F.3d 983 (9th Cir. 2005) (noting that no disparity studies, anecdotal evidence, or consequential formal complaint records were provided); Monterey Mech. Co. v. Wilson, 125 F.3d 702, 704 (9th Cir. 1997) (noting that the state university provided no evidence of prior discrimination and that attempts to rely on legislative findings were unavailing). *See also* W H Scott Constr. Co. v. City of Jackson, Miss., 199 F.3d 206, 218-19 (5th Cir. 1999); Cleveland Constr. v. City of Cincinnati, 169 Ohio App. 3d 627, 641, 2006-Ohio-6452, 864 N.E.2d 116, 127. As the U.S. Commission on Human Rights report noted, courts demand documented evidence of comparisons between firms that are "ready, willing, and able" to do the job, but also will consider critiques of the capacity of "qualified" businesses. *See* USCCR Report, *supra* note 145, at 4.

252. *See* USCCR Report, *supra* note 145, at 76 (listing many recommendations for state and local governments to take before embarking on race-conscious contracting programs); *supra* Part III.C.

253. Rothe Dev. Corp v. Dep't of Def., 545 F.3d 1023, 1042-43 (2008).

254. City of Richmond v. J. A. Croson Co., 488 U.S. 469, 501-02 (1989).

255. Assoc. Gen. Contractors v. Drabik, 214 F.3d 730, 733 (6th Cir. 2000).

other evidence-collection efforts before creating or renewing a program).

First, even if one were able to create a benchmark of "qualified, willing and able" minority managers generally, it would be difficult to match up that data to the specific contract being elicited in each RFP, which are specific to asset classes and market conditions. This is a problem that is uniquely difficult for asset management, for two reasons. One, both investment funds and RFPs are often siloed, so a proper matching would have to be very granular (i.e., explore the benchmark of available minority asset managers who manage international equities). Second, unlike government contracts, qualifications in the asset management business are a sliding scale. Whereas contractors who have the capacity to perform a contract are deemed qualified, there can always be "more" qualified asset managers who bring in higher returns. However, even that parameter is constantly shifting; there is no objective measure of what manager is actually most qualified ex-ante.

Second, it would be very difficult to create a benchmark of minority asset managers that are "qualified, willing, and able"[256] to perform the contract of managing assets for any given fund, especially since the way that allocations are divided are not consistent from time to time, and strategies and capacities of investment funds shift frequently.

Third, asset managers are scattered nationwide; PPFs rarely perform RFP searches only within a geographic area.[257] This triggers the problem that courts are concerned about: that there is a geographic mismatch between evidence and programming.[258]

Fourth, there is no good way to get around some of the issues presented by challenging plaintiffs, which courts have at least partially considered. For example, there is just no way to account for numerical noise created by funds or firms splitting off[259] (which would artificially create a greater denominator in the availability benchmark), or for funds that do not choose to be listed among certified minority business enterprises or whatever listings that end up being considered by disparity studies.[260]

256. *See Rothe*, 545 F.3d at 1037-38; USCCR Report, supra note 145, at 4.

257. There are exceptions to this, such as the Philadelphia Pension Board's most recent diverse manager search. *See* Olsen, *supra* note 123.

258. *See Rothe*, 545 F.3d at 1049; O'Donnell Const. Co. v. D.C., 963 F.2d 420, 427 (D.C. Cir. 1992); Coral Const. Co. v. King Cnty., 941 F.2d 910, 917 (9th Cir. 1991).

259. *See Rothe*, 545 F.3d at 1049; *Drabik*, 214 F.3d at 736-37.

260. *Drabik*, 214 F.3d at 737.

If PPFs are to rely on generalized studies of overall disparities in the asset management business, they would almost certainly fail. Courts have rejected the general societal discrimination rationale as insufficient for state and local governments to take on affirmative action programs.[261] Indeed, even if the U.S. Congress were to recognize the overall disparities studies, courts are still certain to require evidence individualized for each state actor.[262] One possible way for PPFs to meet the evidentiary burden is by showing that the capacity of minority asset managers was far larger than those hired by the funds. However, even this is difficult because unlike qualifications in government contracting, where a bidder is evaluated based on whether it is able to complete the task, in investing, capacity is only one of many factors that go into determining whether a particular asset manager is qualified to invest money for the institution. These other factors could include soft factors like client service, or run against minority funds (track record, AUM).

Even if the PPFs supplied enough evidence that discrimination existed, there may be yet another level of analysis before they can prove compelling state interest. If the PPFs' evidence show that the funds themselves are the source of discrimination, then the inquiry for compelling state interest would be shorter because the government's attempt to eradicate its own discrimination is afforded more automatic deference under the *Croson* analysis.[263] However, unless PPFs are willing to admit that they did engage in discriminatory practices in the past – a very unpalatable thing to say, for both political and public-relations reasons, it is likely that the narrative advanced is that the asset management industry – a private industry – has historically been

261. City of Richmond v. J. A. Croson Co., 488 U.S. 469, 505 (1989).

262. *Croson's* requirements that states implementing federal affirmative action statutes must independently establish compelling state interest instead of relying on Congressional findings of discrimination appear to have been undermined by some Courts of Appeal, which have deemed constitutional the practices of some states to "rely upon [some] Congressional findings to establish evidence of a compelling interest." Zehrt, *supra* note 143, at 17 (citing N. Contracting, Inc. v. Ill., 473 F.3d 715, 721 (7th Cir. 2007); Sherbrooke Turf, Inc. v. Minn. Dep't of Transp., 407 F.3d 964, 970-71 (9th Cir. 2003)). It is unclear if this interpretation will survive review in other Courts of Appeal or by the Supreme Court, but in any case for present purposes, states that do have diversity manager programs for their pension fund management are not relying on federal statutes, nor on any sort of independent *or* Congressional findings of discrimination. Nor is it clear that a nationwide study would benefit states, since the availability of emerging managers on a national level may be much higher than in a given locale.

263. *See Croson*, 488 U.S. at 491-92. However, as Ian Ayres and Frederick Vars point out, a number of federal courts continued to apply the *Wygant* language that limited race-conscious programs to remedy only discrimination by the "government unit involved" even years after the *Croson* decision. *See* Ian Ayres & Frederick Vars, 98 COLUM. L. REV. 1577, 1583 n.17 (1998) (collecting cases).

foreclosed to minority managers. Sufficient evidence of private discrimination, however, does not automatically translate to government remedy. *Croson*'s suggestion that only when the government becomes a "passive participant in a system of racial exclusion practiced by elements of the local . . . industry."[264]

The Supreme Court has not opined further on what this means, but analysis by Ian Ayres and Frederick Vars suggests that it could constitute one of three possible scenarios.[265] The first is that the government's program would ensure that it would not cause private discrimination (i.e. if contractors hired by the city discriminated in taking on subcontractors), and the second is that the government would use affirmative action to utilize minority business as much as it would have "but for" the effects of private discrimination tamping down on minority firms' ability to compete (i.e., if private associations discriminated against minority practices and the associations were also feeders to government contracts). This would be restricted to estimating the capacity of existing minority firms but-for discrimination, not the total capacity of firms that would have existed but-for discrimination. Ayres and Vars argue that both the causal and but-for scenarios are within the contemplation of *Croson*'s stance that the government can remedy private discrimination if it would otherwise be a "passive participant" in that discriminatory scheme.[266] Their final suggestion is the "single-market justification" scenario, whereby "[t]he government should be able to use affirmative action in procurement . . . to correct shortfalls in private purchasing caused by private discrimination."[267]

Should the PPFs attempt to justify their programs along these three dimensions, they would again need to root their analysis in ample evidence. To prove the causal link, they would need to show that a private actor – perhaps a consulting firm that channels investment managers to public institutional funds – discriminates against minority firms, and thus the government needs to enact a program to prevent itself from being complicit in funding a discriminatory process. To prove the but-for link, they would need to show that existing minority asset managers could have been able to manage more public fund assets but for the effects of private discrimination, and the PPF program would accordingly remedy that differential. To prove the single-market justification, they would have to show that private funds – such as endowments, corporate pensions, etc. in the same "market" systemati-

264. *Croson*, 488 U.S. at 490-92.
265. Ayres & Vars, *supra* note 263, at 1585-86.
266. *Id.*
267. *Id.* at 1587.

cally discriminate against minority managers, and the PPF's affirmative action is to remedy that effect.

But these are just hypotheticals. It is not clear at all if the consulting firms that facilitate manager searches have a history of discrimination.[268] Even if there was some evidence of discrimination, the pensions may not want to indict their business relationships with these consulting firms. The single-market hypothetical is also merely speculative at best: corporate pensions are themselves embracing diversity initiatives, which directly counters the assertion that government funds need to enact affirmative action programs to combat private discrimination by private funds; if anything, the logic cuts the other way.

These analyses reveal a theme undergirding the challenges facing PPFs facing the strict scrutiny gauntlet: it is difficult to articulate the source of discrimination that gives rise to inequitable distributions in both the number of minority firms in the market and the percentage of institutional assets managed by minority firms. Without indicting a fixed source of discrimination, it is difficult to see how courts could find a compelling state interest based on substantive evidence of past discrimination.

The argument often used by some PPFs in promoting their diversity initiatives - that pensions programs utilize too few minority and women-owned firms - would almost certainly fail under the *Croson* standard. In *Croson*, the court explicitly rejected as unpersuasive the statistical study that demonstrated that though half of the City of Richmond's population - i.e. the presumptive "users" of public projects - was African-American, less than 1% of its prime construction contracts went to minority businesses.[269] In other words, making the pool of government contractors reflect the pool of the population is not likely to be a compelling state interest.

Another possible but likely unsuccessful justification would be that PPFs' preference for diverse firms could be a catalyst to increase the credibility and viability of diverse firms. As Pilar Avila, CEO of the New America Alliance stated at a CalPERS Emerging and Diverse Manager event stated, the impact of CalPERS's program and ones like it reverberates. "You know, the reality for, for small managers, diverse managers is that a yes from CalPERS is a big yes. It's a big seal of approval."[270] The idea of PPFs as leaders and incubators that

268. In fact, the idea for an emerging/diverse manager index was co-founded in the early 1990s by Ed Callan, the founder of a major pension asset management consulting firm, Callan Associates. *See Progress Investment Interactive Timeline*, *supra* note 23.

269. *Croson*, 488 U.S. at 479-80.

270. Transcript Part 2, *supra* note 79, at 14.

may lead to market change is a compelling one, but it once again meets the same dead end as other rationales facing the strict scrutiny test set forth in *Croson*. Courts are unlikely to find these statements persuasive. However, they are likely to be concerned about the corollary of large PPFs leading the charge in pushing to prominence certain diverse firms: that the rejection of other firms may send an opposite message. As Avila put it immediately after her previous statement, "Likewise, a no from CalPERS it really could mean, or be interpreted as many other things by the market."[271]

### C. *Challenges in Narrowly Tailoring a Diverse Manager Program*

At this point, it should be fairly obvious that notwithstanding the compelling state interest problem, the PPFs also face a narrow tailoring problem. The specific factor within narrow tailoring analysis that appears to run across all the PPFs that have explicit diverse manager programs is the issue of over- and under-inclusiveness. Because minority managers are generally defined very broadly, and because there is not enough evidence establishing that various racial groups are similarly burdened by historical discrimination in the asset management business, it is unlikely that courts would consider these programs narrowly tailored. This also affects the analysis of proportionality, because the lack of evidentiary basis in level of disparity for each group means there cannot be a matching of the remedial goal to the level of disparity.

That the programs are not necessarily long term set-asides (new RFPs can always be issued and allocations can always be shifted), and that at least some states require annual reports on the progress of the program, seem to vitiate in favor of some of the narrow tailoring factors. In addition, some programs that also use race-neutral means of accomplishing similar goals might be more likely to survive the narrow tailoring test. However, these programmatic features are still unlikely to prevail given the lack of disparity evidence.

## VI. CONCLUSION

U.S. pension fund diversity initiatives as a whole can be impactful in a number of arenas, including in the field of fiduciary duty as well as the ability of certain institutions to bring about long-term market and social change. However, the biggest legal issue facing PPF programs in minority manager hiring is whether they could withstand Constitutional review.

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271. *Id.*

In this paper, I have drawn the map of the broader context of PPFs' diversity initiatives, which include other efforts that do not involve race or gender-based classifications. These programs, such as publicly supporting more corporate board diversity, collecting information from asset managers about their diversity composition, supporting third-party actors that create databases of emerging and diverse managers, are not problematic on a constitutional level. Taken as a whole, the package of diversity initiatives the PPFs pursue – with or without the diverse manager component – implicate a number of important issues for the industry.

First, some critics may question whether public pensions' commitment to promoting diversity in any of the methods above is consistent with their legal fiduciary duties to its beneficiaries. This critique follows a similar line of logic to the debates over whether corporations and pension funds should engage in socially-responsible investing. Criticisms of socially-responsible investing ("SRI") focus on the failure of the SRI strategies to pursue objectives other than financial interest maximization.[272] They argue that the pursuit of noneconomic factors at the expense of financial interest maximization for the beneficiary would be a breach of the pension's fiduciary duties.[273] Under this line of argument, so, too would prioritizing noneconomic interests in manager selection, which represents a drift from the pension's core purpose. The cost of lost performance would have to be made up by public taxpayers.

Indeed, it is possible to categorize the pursuit of diversity as a social initiative along the same lines of promoting environmentally-responsible business practices. The crux of this inquiry is whether and how the fund is bound to generate highest returns possible for its beneficiaries. Even if profit maximization is the only goal, there is also room for debate about how long of a time horizon that goal is to take place. In other words, the question is whether promoting long-term gains in more talent entering the asset-management business can be thought of as a legitimate aim of a fiduciary.

A second is the signaling values of such a program and how it could lead to structural changes in the asset management market. This issue is one that funds like CalPERS and CalSTRS appear to take seriously. Even without minority manager programs, PPFs can make great strides in creating a signaling effect for the market. As Ed Dandridge, the head of the NAIC, noted, "CalPERS by virtue of its historic lead-

272. *See* John H. Langbein & Richard A Posner, *Social Investing and the Law of Trusts*, 79 MICH. L. REV. 73 (1980).

273. *Id.* at 96.

ership, by virtue of its size, by virtue of the demonstrated leadership that the Board has used to great effect ton corporate governance, as well as in [the investment] space, comes with it a great opportunity to help advance the common interest."[274] In a way, even if the diversity initiatives are in the short term benefit-neutral for the PPFs (i.e., if diversity of actors has no effect on corporate governance or asset manager returns), it may still be worth promoting. The actions of these large pools of institutional money acting in the interest of diversity may signal to market players, such as women and minority-owned firms, or potentially "board-ready" minorities and women, that they would be unlikely to face invidious discrimination if they were to seek those positions. In addition, as we have seen in the SEC context, the actions of PPFs may spur action by other actors, such as government agencies themselves.

The potential signaling and market-changing effects of PPF actions on diversity are interesting, and possibly very encouraging. However, they will be stymied if the pension funds are unable to defend itself against challenges to a subset of its diversity-programs: diverse hiring practices. Thus, PPFs should be extremely careful in evaluating and reevaluating programs to hire minority or women-owned investment managers. Though these programs have yet to be challenged – possibly because there are low incentives for any given asset manager to do so – one suit could begin the unraveling of programs nationwide. The straitjacket of strict scrutiny is indeed tight, and PPFs would have to do a lot of maneuvering in evidence-gathering and program design to escape the death knell of a legal test that is not quite "fatal" in fact, but certainly brutal in its ability to incapacitate existing affirmative action programs across the country.

274. Transcript Part 2, *supra* note 79, at 8.

# VII. APPENDICES

## APPENDIX A-1: CHART OF EXAMPLE RFPS FOR DIVERSE AND EMERGING MANAGERS

| FUND NAME | FUND SIZE (M) | INVESTMENT TYPE | SIZE (M) | COMMENTS |
|---|---|---|---|---|
| NEW LEADS | | | | |
| Los Angeles Fire & Police Pension System | 16,439 | Manager-of-Managers | 200 | Plan has issued an RFI for emerging manager-of-managers to handle a portion of its domestic equity portfolio totaling between $50 million and $200 million. A copy of the RFI is available on the plan's Web site (http://www.lafpp.com/LAFPP.documents/RFPs/Emerging_Fund_of_Funds_Manager_Search_RFI_2013.pdf) and the deadline for proposals is Oct. 29. Incumbents Attucks Asset Management and FIS Group are invited to rebid. |
| Philadelphia Public Employees Retirement System | 4,327 | Active Equity | N/A | Plan has issued an RFP for diverse, emerging and local domestic equity managers. A copy of the RFP is available on the city's purchasing Web site (https://secure.phila.gov/ECONTRACT/Documents/frmPDFWindow.aspx?docid=21130923120826021130824151538 1N&ext=pdf). The deadline for proposals is Oct. 15. |
| Illinois State Board of Investment | 13,116 | International Equity | 70 | Plan has issued RFP for women-, minority- and/or disabled-owned firm to handle up to $70 million in an international equity strategy benchmarked to the MSCI ACWI ex-U.S. index. RFP is available on plan's Web site (http://www2.illinois.gov/isbi/Documents/ISBI-Emerging-Minority-International-Equity.doc) and proposals are due Oct. 15. |
| Laborers' and Retirement Board Employees' Annuity and Benefit Fund of Chicago | 1,358 | Manager-of-Managers | N/A | Plan was scheduled to discuss the advantages and disadvantages of participating in an internally-managed emerging manager program at its Sept. 17 board meeting, according to the August minutes. Northern Trust, which currently serves as the plan's emerging manager-of-managers, has been on watch for performance reasons since 2010. No other information is available at this time. |
| City of Baltimore Employees Retirement System | 1,300 | Manager-of-Managers | N/A | Plan expanded the mandate scope of emerging manager-of-managers FIS Group to include global equity at its Aug. 15 board meeting. |
| Los Angeles County Employees Retirement Association | 40,000 | Private Equity | N/A | Plan intends to conduct a full review of its existing private equity emerging manager-of-managers program and issue an RFP in the near future. The program is currently managed by J.P. Morgan Private Equity Group. |

*Search Roundup*, 8 EMERGING MANAGER MONTHLY 15 (Oct. 2013). Reprinted with permission.

## APPENDIX A-2: EXAMPLE OF RFP REQUIRING DIVERSITY DISCLOSURES FROM INVESTMENT MANAGERS

Chicago Teacher's Pension Fund
DIVERSITY PROFILE – External Managers
Name of Asset Management Firm
as of December 31, 2011

| | Hispanic or Latino | | Non-Hispanic or Latino | | | | | | | | | | | | | | |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| | | | MALE | | | | | | | FEMALE | | | | | | | |
| Job Categories | Male | Female | White | Black or African American | Hawaiian or Other Pacific Islander | Asian | American Indian or Alaska Native | Two or More Races | White | Black or African American | Hawaiian or Other Pacific Islander | Asian | American Indian or Alaska Native | Two or More Races | Overall Totals |
| Exec / Sr Officials & Managers | | | | | | | | | | | | | | | 0 |
| Investment Professionals (Excluding Traders) | | | | | | | | | | | | | | | 0 |
| Investment Professionals (Traders) | | | | | | | | | | | | | | | 0 |
| Professionals - Operations, Compliance, etc. | | | | | | | | | | | | | | | 0 |
| Professional - Sales / Marketing & Client Services | | | | | | | | | | | | | | | 0 |
| Administrative Support, Office/Clerical | | | | | | | | | | | | | | | 0 |
| Other Non-Professionals | | | | | | | | | | | | | | | 0 |
| Total | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 | 0 |
| Percent of Total | #DIV/0! | #DIV/0! | #DIV/0! | #DIV/0! | #DIV/0! | #DIV/0! | #DIV/0! | #DIV/0! | #DIV/0! | #DIV/0! | #DIV/0! | #DIV/0! | #DIV/0! | #DIV/0! | #DIV/0! |

Notes: Table format and categories for race/ethnicity derived from the US Department of Labor Equal Employment Opportunity Employer Information Report (EEO-1).

Complete Diversity Profile for your total firm or US workforce only or by Business Unit. Please also complete the Diversity Profile for the team responsible for the CTPF portfolio.
Report Full-Time employees only and report employees in only one category. Please do not change table format.

*Chicago Teachers' Pension Fund Request for Proposals: Emerging Markets Equity Manager Search*, CHI. TEACHERS' PENSION FUND 16 (2012), *available at* http://www.ctpf.org/general_info/rfps/emergingmarkets2012.pdf. Reprinted with permission.

## APPENDIX B: STATE PENSIONS FUNDING STATUS

| State | Actuarial Assets | Market Liability | Funded Ratio | Unfunded Liability |
|---|---|---|---|---|
| **Alabama** | $27,902,559 | $82,669,822 | 34% | $54,767,263 |
| **Alaska** | $10,108,098 | $33,579,228 | 30% | $23,471,130 |
| **Arizona** | $30,359,859 | $79,925,775 | 38% | $49,565,916 |
| **Arkansas** | $6,864,900 | $18,711,205 | 37% | $11,846,305 |
| **California** | $415,621,000 | $995,095,267 | 42% | $579,474,267 |
| **Colorado** | $12,538,675 | $41,576,848 | 30% | $29,038,173 |
| **Connecticut** | $23,479,800 | $97,439,982 | 24% | $73,960,182 |
| **Delaware** | $7,565,440 | $15,680,810 | 48% | $8,115,370 |
| **Florida** | $127,891,781 | $280,543,392 | 46% | $152,651,611 |
| **Georgia** | $67,688,311 | $151,447,824 | 45% | $83,759,513 |
| **Hawaii** | $12,242,500 | $39,193,563 | 31% | $26,951,063 |
| **Idaho** | $11,306,200 | $24,516,498 | 46% | $13,210,298 |
| **Illinois** | $63,372,566 | $314,857,111 | 20% | $251,484,545 |
| **Indiana** | $21,002,787 | $60,375,598 | 35% | $39,372,811 |
| **Iowa** | $23,530,094 | $53,887,720 | 44% | $30,357,626 |
| **Kansas** | $13,278,490 | $46,167,691 | 29% | $32,889,201 |
| **Kentucky** | $18,289,914 | $72,317,917 | 25% | $54,028,003 |
| **Louisiana** | $24,014,289 | $86,835,337 | 28% | $62,821,048 |
| **Maine** | $11,076,400 | $24,761,724 | 45% | $13,685,324 |
| **Maryland** | $34,089,464 | $101,771,068 | 33% | $67,681,604 |
| **Massachusetts** | $42,649,119 | $130,540,526 | 33% | $87,891,407 |
| **Michigan** | $10,212,000 | $30,600,677 | 33% | $20,388,677 |
| **Minnesota** | $27,345,756 | $73,262,495 | 37% | $45,916,739 |
| **Mississippi** | $19,992,797 | $67,673,609 | 30% | $47,680,812 |
| **Missouri** | $7,897,167 | $21,176,705 | 37% | $13,279,538 |
| **Montana** | $7,347,601 | $21,914,863 | 34% | $14,567,262 |
| **Nebraska** | $1,418,153 | $3,023,170 | 47% | $1,605,017 |
| **Nevada** | $27,399,000 | $75,741,238 | 36% | $48,342,238 |
| **New Hampshire** | $5,861,896 | $19,751,867 | 30% | $13,889,971 |
| **New Jersey** | $42,800,310 | $147,143,964 | 29% | $104,343,654 |
| **New Mexico** | $21,218,347 | $63,717,053 | 33% | $42,498,706 |
| **New York** | $147,809,000 | $309,763,562 | 48% | $161,954,562 |
| **North Carolina** | $58,125,011 | $109,297,356 | 53% | $51,172,345 |
| **North Dakota** | $3,375,500 | $10,541,999 | 32% | $7,166,499 |
| **Ohio** | $124,925,508 | $367,278,792 | 34% | $242,353,284 |
| **Oklahoma** | $20,466,046 | $60,727,151 | 34% | $40,261,105 |
| **Oregon** | $44,943,100 | $120,068,763 | 37% | $75,125,663 |
| **Pennsylvania** | $83,530,310 | $239,398,931 | 35% | $155,868,621 |
| **Rhode Island** | $6,167,492 | $19,527,153 | 32% | $13,359,661 |
| **South Carolina** | $29,349,683 | $82,013,612 | 36% | $52,663,929 |
| **South Dakota** | $7,828,000 | $14,938,398 | 52% | $7,110,398 |
| **Tennessee** | $36,680,783 | $73,328,483 | 50% | $36,647,700 |
| **Texas** | $142,598,556 | $340,996,932 | 42% | $198,398,376 |
| **Utah** | $20,386,602 | $49,001,616 | 42% | $28,615,014 |
| **Vermont** | $2,918,189 | $7,943,333 | 37% | $5,025,144 |
| **Virginia** | $54,473,000 | $133,823,921 | 41% | $79,350,921 |
| **Washington** | $59,564,000 | $122,563,542 | 49% | $62,999,542 |
| **West Virginia** | $9,397,333 | $27,378,131 | 34% | $17,980,798 |
| **Wisconsin** | $78,940,000 | $138,707,039 | 57% | $59,767,039 |
| **Wyoming** | $6,187,203 | $15,289,057 | 40% | $9,101,854 |
| **Total** | $2,114,030,589 | $5,518,488,319 | 38% | $3,404,457,730 |

State Budget Solutions 50 State Pension Table, STATE BUDGET SOLUTIONS (Sept. 3, 2013), http://www.statebudgetsolutions.org (all figures except Per Capita in thousands). Reprinted with permission.

## APPENDIX C: POST-*CROSON* CASE SUMMARY

### LOWER COURT CASES POST-*CROSON* & *ADARAND*

| Case citation | Type of Evidence | Compelling State Interest | Narrow Tailoring | Constitutional? | State/Fed program |
|---|---|---|---|---|---|
| Associated Gen. Contractors of Am., San Diego Chapter, Inc. v. California Dep't of Transp., 713 F.3d 1187 (9th Cir. 2013) | - disparity studies, anecdotal evidence | Yes | Yes | YES | Federal program w/state implementation |
| Concrete Works of Colorado, Inc. v. City and County of Denver, 321 F.3d 950 (10th Cir. 2003) | - Federal agency reports, disparity studies, anecdotal evidence | Yes | Yes (district court did not err) | YES | State |
| Northern Contracting, Inc. v. Illinois, 473 F.3d 715 (7th Cir. 2007); | - custom census, other market studies, anecdotal evidence, department's own statistics, "zero goal" experiment | Yes (relying on federal evidence of CSI) | Yes (state insulated when acting as instrument of federal policy) | YES | Federal program w/state implementation |
| Sherbrooke Turf, Inc. v. Minn. Dep't of Transp., 345 F.3d 964 (8th Cir. 2003) | - statistical studies, anecdotal evidence | Yes (relying on federal evidence of CSI) | Yes | YES | Federal program w/state implementation |
| Adarand Constructors, Inc. v. Slater, 228 F.3d 1147 (10th Cir. 2000) | - disparity studies, historical evidence | Yes | Yes | YES | Federal |
| Rothe Dev. Corp v. DOD, 545 F.3d 1023 (2008) | - six disparity studies, other statistics, congressional hearings with anecdotal evidence | No | Does not reach question | NO | Federal (DOD program) |
| H.B. Rowe Co., Inc. v. Tippett, 615 F.3d 233 (4th Cir. 2010) | - disparity/ utilization studies, anecdotal evidence | Yes | Yes | YES (some races, not gender) | State |
| Virdi v. DeKalb Cnty. Sch. Dist., 135 F. App'x 262, 267 (11th Cir. 2005) | n/a | Does not reach | No | NO | State |
| W. States Paving Co. v. Wash. Dep't of Transp., 407 F.3d 983 (9th Cir. 2005) | - Congressional: utilization study, financing utilization study, historical evidence.<br>- State level: no disparity studies, no anecdotal evidence, no consequential formal complaints | - federal standard meets CSI (deferential to other circuits?)<br>- state can rely on federal CSI but not NT | - Federal - Yes<br>- State - not narrowly tailored | NO | Both Facial challenge to federal program As-applied challenge to Washington DOT |

| Case citation | Type of Evidence | Compelling State Interest | Narrow Tailoring | Constitutional? | State/ Fed program |
|---|---|---|---|---|---|
| MD/DC/DE Broadcasters Assoc. v. Federal Communications Comm'n, 236 F.3d 13 (D.C. Cir. 2001) | n/a | Does not reach | No | NO | Federal |
| Builders Ass'n of Greater Chi. v. County of Cook, 256 F.3d 642 (7th Cir. 2001) | - "no specific evidence of pre-enactment discrimination", some testimonial evidence | No | No | NO | State |
| Associated Gen. Contrs. of Ohio, Inc. v. Drabik, 214 F.3d 730 (6th Cir. 2000) | - some statistical analysis of disparity | No | No | NO | State |
| W H Scott Constr. Co. v. City of Jackson, Miss., 199 F.3d 206 (5th Cir. 1999) | - disparity studies | No | Did not reach | NO | State |
| Lutheran Church-Mo. Synod v. Fed. Commc'n Comm'n, 141 F.3d 344 (D.C. Cir. 1998) | n/a | No (CSI argument relied only on diversity) | No | NO | Federal |
| Eng'g Contractors Ass'n of S. Fla. Inc. v. Metro. Dade County, 122 F.3d 895 (11th Cir. 1997) | Disparity study, rebuttal, and regression analysis, marketplace analysis, and other studies | No | No | NO | State |
| Monterey Mech. Co. v. Wilson, 125 F.3d 702 (9th Cir. 1997) | No evidence of anything other than "legislative findings" | No | No | NO | State |
| Contractors Ass'n of E. Pa. v. City of Phila., 91 F.3d 586 (3rd Cir. 1996) | - disparity study | Does not reach conclusion | No | NO | State/local |
| O'Donnell Const. Co. v. D.C., 963 F.2d 420, 427 (D.C. Cir. 1992) | - comparison of populations, anecdotal evidence | No | No | NO | State (DC) |
| Coral Const. Co. v. King Cnty., 941 F.2d 910, 917 (9th Cir. 1991) | no statistical data but numerous affidavits | Remanded | No | NO | State |

| Case citation | Type of Evidence | Compelling State Interest | Narrow Tailoring | Constitutional? | State/ Fed program |
|---|---|---|---|---|---|
| Shurberg Broad. of Hartford, Inc. v. F.C.C., 876 F.2d 902, 926 (D.C. Cir. 1989) rev'd sub nom. Metro Broad., Inc. v. F.C.C., 497 U.S. 547, 110 S. Ct. 2997, 111 L. Ed. 2d 445 (1990) overruled by Adarand Constructors, Inc. v. Pena, 515 U.S. 200, 115 S. Ct. 2097, 132 L. Ed. 2d 158 (1995) | no hard evidence of disparity | No | No | NO (reversed, then reversed again) | Fed |
| Associated Gen. Contractors of California, Inc. v. Coal. for Econ. Equity, 950 F.2d 1401, 1414 (9th Cir. 1991) | - testimonial evidence, statistical evidence | Sufficient evidence to survive PJ motion | Sufficient evidence to survive PJ motion | Survives PJ motion by P | State/local |
| Cleveland Constr., Inc. v. City of Cincinnati, 864 N.E.2d 116 (Ohio Ct. App. 2006) | - unclear at trial, but not much evidence | No ("effectively conceded") | did not reach | NO | State |
| Ritchey Produce Co., Inc. v. Ohio Dep't of Adm. Serv., 1999-Ohio-262, 85 Ohio St. 3d 194, 254, 707 N.E.2d 871, 914 | - statistical studies | Yes | Yes | YES | State |
| L. Feriozzi Concrete Co., Inc. v. Casino Reinvestment Dev. Auth., 776 A.2d 254 (N.J. Super. Ct. App. Div. 2001) | n/a | Parties assumed yes | No | NO | State |
| Am. Subcontractors Ass'n, Georgia Chapter, Inc. v. City of Atlanta, 259 Ga. 14, 18, 376 S.E.2d 662 (1989) | - old federal study, some statistical evidence, anecdotal evidence from public hearings | No | No | NO | State |