

# INVESTMENT DIVERSITY IN PUBLIC SECTOR RETIREMENT PLANS

**A WHITE PAPER**

**by**

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# INVESTMENT DIVERSITY IN PUBLIC SECTOR RETIREMENT PLANS

## EXECUTIVE SUMMARY

There is a growing recognition in this country of the importance of gender and ethnic diversity across all segments of society, from the social to the economic. In the public sector, state laws and local ordinances emphasize that minority-owned and women-owned business enterprises (MWBES) should be included in contractual dealings with government entities. This diversity policy extends to the retirement and deferred compensation plans of these entities (or “Plans”).

Illinois law, for example, encourages Plan fiduciaries to increase ethnic and gender diversity “within the bounds of financial and fiduciary prudence.” Maryland law is similar. But local ordinances in cities and counties – in Chicago and Cook County, for example – may contain a mandate, requiring that a portion of the compensation of government contractors be paid to MWBES.

These state and local requirements create a challenge for those responsible for the Plan investments, the Plan fiduciaries. The fiduciaries are required under the laws of most states to act prudently in managing a Plan’s investments for the exclusive purpose of providing benefits to the participants.<sup>1</sup> But this raises a question: is it prudent to select investments or investment managers based only on whether they meet stated MWBE goals? In essence, fiduciaries need to satisfy both sets of requirements...prudence and diversity, as reflected in the Illinois and Maryland laws and local ordinances.

Nationwide Financial, through its funds group (Nationwide), has introduced an investment fund that is designed to help government plan fiduciaries satisfy both requirements. It is a balanced fund that invests in domestic and international equities and fixed income securities using carefully selected money managers.

Nationwide, as the adviser of the fund, has engaged four sub-advisers that are MWBES, each managing a different asset class. The fund is called the Diverse Managers Fund (DMF). Each of the money managers has been selected by Nationwide using a rigorous

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<sup>1</sup> State and local government plans are not subject to the federal Employee Retirement Income Security Act of 19745 (ERISA).

and intensive process, the same process it uses for selecting all the managers of assets for which Nationwide is responsible.

The DMF may help Plan fiduciaries solve the MWBE conundrum, that is, the selection of a prudent investment that also satisfies state laws on fiduciary prudence and about the use of MWBE managers, and local ordinances requiring that a portion of a Plan's fees be paid to MWBEs.

Fiduciaries must act prudently – they must make their own informed decisions – in selecting the investments, including the DMF, for their Plan. At the same time, they may be able to rely on Nationwide's due diligence in choosing the DMF money managers. Through that process, Nationwide provides material assistance to Plan fiduciaries by:

- Providing a balanced fund that assists Plans and participants achieve a diversified portfolio across multiple asset classes;
- Helping fiduciaries reach ethnic and gender diversity goals by employing qualified MWBE investment managers; and
- Assisting fiduciaries in satisfying the prudent man requirements of state pension laws by considering the process used by an investment expert.

This White Paper discusses these concepts in more depth.

## DISCUSSION

### Introduction

Demographic and other changes in American society have created an awareness of the role played by ethnic and gender diversity in our society. In turn, this awareness has spurred the promotion of diversity in contractual dealings, especially in the public sector. In this connection, state and local governments have taken steps to help achieve, as a matter of policy, a more diverse business environment. This objective is accomplished, in part, by requiring that a portion of the products and services purchased by public entities be provided by minority or women-owned business enterprises (MWBEs). These social policies have been implemented through the adoption of state laws and local ordinances that encourage or mandate the use of MWBEs.

The move toward ethnic and gender diversity extends to public-sector retirement and deferred compensation plans. One way to realize these goals is through the selection of investments that are managed by MWBEs. To help facilitate MWBE diversity in public-sector plans, Nationwide Financial, through its funds group (referred to as “Nationwide”) has developed the Diverse Managers Fund, a balanced mutual fund, in which the underlying assets are managed by MWBEs.

The purpose of this white paper is to discuss the opportunities and challenges of using MWBE investment managers. In this paper, we address the following questions:

- What state laws and local ordinances impact the selection of MWBE-managed investments for public sector plans? In answering this question, as examples, we reference laws in Illinois and Maryland and local ordinances in Cook County and Chicago, Illinois, that address the diversity issue. We believe that the statutes and ordinances of these jurisdictions are representative of those in many other states, counties and cities and other governmental entities.
- What are the fiduciary issues for the selection of such investments? This discussion focuses on the impact of the diversity requirement on the fiduciary obligations of those who administer public-sector plans.
- What products or services are available to assist public sector plan fiduciaries in fulfilling their duties for the selection of such investments? For this question, we discuss how Nationwide and the Diverse Managers Fund may help government

plan fiduciaries fulfill both their duty to prudently select investments that also help satisfy the goal of achieving ethnic and gender diversity.

The next section of this paper summarizes the legal analysis related to the MWBE and fiduciary requirements of state and local law. A full discussion of the fiduciary requirements appears in Appendix A. We discuss the MWBE requirements in Appendix B, and describe the Nationwide Diverse Managers Fund (DMF) in Appendix C.

First, we discuss the fiduciary rules, then summarize the state and local MWBE requirements applicable to Plans and conclude with a description of the essential elements of the DMF.

## Summary of Legal Analysis

### *Fiduciary Requirements*

Those responsible for selecting the investments in governmental retirement and deferred compensation plans<sup>2</sup> are generally required to act prudently. This obligation is set out in state law provisions governing the conduct of fiduciaries. For example, the Illinois Pension Code describes the duty of fiduciaries of public sector plans.<sup>3</sup> The Code requires that the fiduciaries act:

“(a) For the exclusive purpose of:

(1) Providing benefits to participants and their beneficiaries; and

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(b) With the care, skill, prudence and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and **familiar with such matters** would use in the conduct of an enterprise of a like character with like aims....” [Emphasis added]

These are generally referred to as the “exclusive purpose” requirement and the “prudent man rule.” The wording of these statutes is generally consistent across many jurisdictions. It is also virtually identical with the provisions of the federal Employee Retirement Income Security Act (ERISA), which does not apply to governmental plans. The similarity in wording to the ERISA standard is relevant because the conduct required by the exclusive purpose and prudent man rules are not well-developed under state law – but have been subject to extensive interpretation in court cases, regulations and other guidance issued by the U.S. Department of Labor under ERISA. Since ERISA is the most detailed, comprehensive and developed body of law concerning the management of retirement plans, state courts often look to ERISA authorities for guidance on fiduciary issues. To the extent state law is not well-developed or particularly informative, this white paper discusses guidance under ERISA because we believe state courts will look to that guidance as being instructive about retirement plan fiduciary responsibilities.

Generally, the prudence obligation has been interpreted under ERISA to mean that plan fiduciaries must engage in a prudent process when selecting investments. That is, the acts of fiduciaries are judged largely by how they reached their decisions rather than on the decisions themselves. This is not to say that the decisions are unimportant, but

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<sup>2</sup> For ease of reference, we use the term “Plans” in this paper

<sup>3</sup> 40 Illinois Compiled Statutes Chapter 5 Section 1-109 (hereinafter cited as “Illinois Pension Code”). Maryland law is almost identical in its requirements. *See, also*, Md. Code Ann, State Personnel & Pensions, §21-203. (hereinafter cited “Maryland Pension Code”).

fiduciaries generally will avoid liability for a decision gone awry so long as the steps taken to reach the decision were prudent.

In the investment context, the prudent process requires that fiduciaries gather information about the investment, assess that information and then make an informed and reasoned decision regarding the investment that is in the best interest of the participants.<sup>4</sup> It is important to remember that the prudent man rule, as stated in ERISA and many state laws, makes reference to a person who is “familiar with such matters.” In the context of a retirement plan, this means one who is knowledgeable about investments, especially in the specific context of providing benefits for retirement.

The information to be considered about the investments to be included in a plan includes, among other things, performance, volatility, cost, consistency with stated investment objectives, experience of investment managers, comparison to other similar investments and whether the investment is consistent with the Plan’s investment policy and objectives.<sup>5</sup>

The prudent man rule requires a significant degree of knowledge and experience regarding investments that many fiduciaries may not possess. As a result, it is generally recognized that fiduciaries should engage consultants to assist them in reaching their informed and reasoned decision. In effect, fiduciaries are permitted – indeed, sometimes required<sup>6</sup> – to rely on the data gathering and assessment process of others who possess the required experience and sophistication.

With this statement of the fiduciary requirement, we now turn to the interplay between the fiduciary rule and the MWBE requirements of state and local law.

### *State MWBE Requirements*

To promote the goal of diversity, a number of state and local governments have adopted laws or ordinances requiring support for minority and women owned businesses (MWBEs).<sup>7</sup> These include minimum MWBE requirements for those who contract to

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<sup>4</sup> ERISA Regulation §2550.404a-1(b).

<sup>5</sup> These requirements are discussed in more detail later in this white paper and in Appendix A.

<sup>6</sup> ERISA Regulation §2550.404a-1(b).

<sup>7</sup> See Illinois Pension Code §109.1(4); Maryland Pension Code §21-116; Cook County Minority- and Women-Owned Business Enterprise Ordinance, §§10-43.2(B) and 10-43.3(B)(2)(a) and (b) and related regulations; and Chicago Municipal Code, Chapter 2-92-420 and related regulations.



provide services to the governmental entity. These requirements often are also extended to investment and/or service providers to governmental Plans.<sup>8</sup>

The laws in a number of states add an overlay on the fiduciary obligation to act prudently through the adoption of legislative policies that encourage the use of MWBEs in the management of Plan assets. For example, the Illinois statute provides:<sup>9</sup>

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. [Emphasis added]

These types of provisions do not mandate any specific level of MWBE involvement in the management of Plan assets; they only “encourage” the fiduciaries to “increase the racial, ethnic and gender diversity of” a Plan’s investment managers. They state an objective rather than a requirement. But they also contain an admonition: the fiduciaries must do so “within the bounds of” sound fiduciary and financial practice.

Given their structure, these added policies raise a question: if a Plan fiduciary is required to act prudently in selecting investments, but is also strongly urged to employ MWBE investment managers for at least a portion of their investments, does this present a potentially irreconcilable conflict? The short answer is no. This is based on two factors:

- first, guidance provided by the DOL related to the selection of “economically targeted investments” (also referred to as socially responsible investments or SRI);<sup>10</sup> and
- second, the clear public policy expressed in state law.<sup>11</sup>

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<sup>8</sup> While not explicitly applicable to those providing investment advisory or management services to Plans, there is no exception in the Cook County or Chicago ordinances that would exclude them from the MWBE contracting requirements.

<sup>9</sup> Illinois Pension Code §109.1(4). The term “emerging investment managers” refers to MWBEs. Maryland law includes a similar “encouragement.”

<sup>10</sup> See DOL Interpretive Bulletin 08-1, at 29 CFR Section 2509.08-1.

<sup>11</sup> Note that there are also local ordinances that require contracts for the provision of goods or services to contain a commitment by the contractor to expend not less than a specified percentage of the total dollar value of the contract with MWBEs. *See, e.g.,* Chicago Municipal Code, Ch. 2-92-420 et seq. These ordinances are discussed in more detail in the next section of this paper and in Appendix B.

In its SRI guidance, the DOL indicated that it was not impermissible for fiduciaries to consider the social goals of an investment so long as the investment otherwise met the considerations applicable to the selection of a prudent investment. The DOL made it clear, however, that “before selecting an economically targeted investment, fiduciaries must first have concluded that the alternative options are truly equal, taking into account a quantitative and qualitative analysis of the impact on the plan.”<sup>12</sup> In this context, the DOL points out that fiduciaries must consider, among other things, “the level of diversification, degree of liquidity and the potential risk/return in comparison with available alternative investments.”

In essence, the DOL says that so long as an investment meets the criteria that would normally be applied in the prudent selection of that investment, the fact that it also satisfies a public policy goal is acceptable.

This position is consistent with the policy expressed in the Illinois law quoted above. That is, the state law encourages fiduciaries to “increase the racial, ethnic, and gender diversity of its fiduciaries,” but makes it clear that they must do so “within the bounds of financial and fiduciary prudence.” By analogy to the DOL Interpretive Bulletin, it is permissible for fiduciaries of governmental plans to take into account the MWBE status of the investment managers of a fund in selecting that investment for the Plan – in fact, the state law encourages them to consider that status – so long as the fund otherwise meets the requirements for a prudent investment.

#### *Local MWBE Requirements*

City and county ordinances contain more explicit MWBE requirements. In general, they mandate that a specified percentage of the amounts paid to government contractors must be paid to entities that qualify as minority owned or women owned businesses. For example, the Chicago Municipal Code provides an “award goal” as follows:

The chief procurement officer shall establish a goal of awarding not less than 25 percent of the annual dollar value of all contracts to qualified M.B.E.s and five percent of the annual dollar value of all contracts to qualified W.B.E.'s.<sup>13</sup>

If a contractor fails to demonstrate that it is in compliance with this requirement, its contract can be terminated.<sup>14</sup>

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<sup>12</sup> *Id.*

<sup>13</sup> Chicago Municipal Code, Ch. 2-92-430.

<sup>14</sup> *Id.* at Ch. 2-92-440(e)(iii) and (iv).

The local ordinances are sufficiently broad that they are often interpreted by the local authority to apply to those that provide investment management functions to Plans sponsored by the city or county or their agencies.<sup>15</sup> In this sense, the local ordinances place an added burden on the Plan fiduciaries to ensure that Plan service providers are fulfilling the MWBE requirements.

In the next section, we discuss the Nationwide Diverse Managers Fund and how it may help Plan fiduciaries meet the state and local goals for achieving MWBE diversity.

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<sup>15</sup> Discussion by authors with Cook County chief procurement officer, July 1, 2014.

## The Diverse Managers Fund

Nationwide has developed an investment fund designed to assist Plans in meeting the goal of MWBE diversity, both the state “encouragement” and the local mandate. Called the Diverse Managers Fund (DMF), it is a multi-manager mutual fund with a balanced mandate. The DMF invests in U.S. stocks, international stocks, micro-cap stocks and fixed-income securities, and is designed to provide a single fund that meets both income and growth objectives of plan fiduciaries or participants. What distinguishes the DMF from other balanced funds is that each asset category is managed by a different MWBE investment management subadviser.

While Nationwide does not serve as a fiduciary to Plans that invest in the DMF under either ERISA or state fiduciary laws, as the investment manager of the DMF, it does take on a fiduciary role under the rules applicable to investment advisers.<sup>16</sup> As the fund manager, it engages in the type of process described by the DOL in selecting the subadvisors of the DMF, employing traditional metrics to assess the qualifications and the retention of the subadvisors (discussed in more detail in Appendix C).

Through the DMF, Nationwide provides material assistance to Plan fiduciaries in a number of key respects.

- First, as a balanced fund, the DMF assists participants in achieving a diversified portfolio across multiple asset classes while at the same time helping to satisfy state and local MWBE goals. Absent such a fund, the participants would be required to construct their own portfolio from among a Plan’s other investment options that have MWBE advisors.
- Second, the DMF helps fiduciaries in reaching the diversity goals of state law and local ordinances by employing qualified MWBE investment managers.
- Third, in light of the due diligence performed by Nationwide in selecting the MWBE managers, the DMF helps satisfy the prudent man requirements of state pension laws by relying on the process engaged in by an investment expert.

Fiduciaries must make their own informed decision about the selection of the DMF for their Plan, but by understanding the process used by Nationwide in selecting the MWBE managers and by reviewing the performance of the DMF, they receive material assistance in fulfilling their obligations.

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<sup>16</sup> *Securities and Exchange Commission v. Capital Gains Research Bureau, Inc., et al.*, 375 U.S. 180 (1963).

## CONCLUSION

Many states and local governments have established goals for ethnic and gender diversity in their contracts with the private sector for goods and services. These requirements are set out in state laws that encourage diversity for the investments in Plans and local ordinances that require that a percentage of contractor payments go to MWBEs. At the same time, Plan fiduciaries are required to meet state fiduciary rules, including the requirement that they act prudently in the selection of investments. When coupled with the diversity goals, this presents a challenge to the fiduciaries...to fulfill the prudent selection requirement but to be mindful of and help foster government diversity policy. Nationwide's Diverse Managers Fund may help fiduciaries in fulfilling this challenge.

## APPENDIX A

### DISCUSSION OF FIDUCIARY REQUIREMENTS

This Appendix discusses the general duties of fiduciaries under state law, then addresses the prudent man standard of care and concludes with a discussion of the selection of investments.

#### **General Fiduciary Duties**

Retirement and deferred compensation plans for state and local employees are exempt from the requirements of ERISA.<sup>17</sup> As a result, the extensive body of law under ERISA that governs the conduct of fiduciaries in the operation and investment of plans does not apply to governmental plans. But state and local government plan fiduciaries are required to comply with state laws that are often virtually identical, or at least substantially similar to, the provisions of ERISA.<sup>18</sup>

ERISA is also the most detailed, comprehensive, and developed body of law concerning the management of retirement plans. State courts, therefore, often look to ERISA for guidance on fiduciary issues. As a result, to the extent the state law is not well-developed or particularly informative, this white paper discusses guidance under ERISA.

The general fiduciary requirements of both state law and ERISA provide that those responsible for the administration and investment of plans act for the exclusive purpose of providing benefits and comply with the “prudent man” standard of care. The Illinois Pension Code, for example, provides that fiduciaries must act:

With the care, skill, prudence and diligence *under the circumstances then prevailing* that a prudent man acting in a like capacity and *familiar with such matters* would use in the conduct of an enterprise of a like character with like aims....<sup>19</sup> [Emphasis added]

Illinois adds an additional provision regarding the use of MWBEs. That section encourages fiduciaries to select investment managers that qualify as MWBEs, while also

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<sup>17</sup> ERISA §4(b).

<sup>18</sup> At least 31 states have adopted laws derived from – and in some cases, verbatim to – ERISA’s “prudent man” standard. States that have incorporated language identical to or very similar to ERISA include Alabama, Alaska, Arizona, Arkansas, California, Colorado, Connecticut, Florida, Idaho, Illinois, Indiana, Kansas, Kentucky, Louisiana, Maryland, Massachusetts, Michigan, Mississippi, Missouri, Montana, Nevada, New Hampshire, Ohio, Oklahoma, Pennsylvania, South Carolina, South Dakota, Tennessee, Texas, Virginia and Washington.

<sup>19</sup> Illinois Pension Code Section 1-109(b).

reminding fiduciaries that they must still be prudent in selecting the investment. The provision 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. [Emphasis added]<sup>20</sup>

Regarding the exclusive purpose requirement, the U.S. Department of Labor (DOL) (the federal agency authorized to interpret and enforce the provisions of ERISA) has explained:

“The Department has construed the requirements that a fiduciary act solely in the interest of, and for the exclusive purpose of providing benefits to, participants and beneficiaries **as prohibiting a fiduciary from subordinating the interests of participants and beneficiaries in their retirement income to unrelated objectives.**”<sup>21</sup> [Emphasis added.]

By “unrelated objectives,” the DOL means that fiduciaries must not consider factors other than providing retirement benefits for participants in making decisions. In other words, the actions fiduciaries (*i.e.*, those responsible for managing the plan and its investments) take and every decision that they make must be consistent with the purpose of providing retirement benefits for the participants.

To meet this objective when making decisions regarding the plan (such as investment selection), fiduciaries must focus on the goal of helping participants accumulate retirement benefits. Government plan fiduciaries cannot prioritize other benefits or features, or the interests of other parties, over the interests of the participants. To do so would be a fiduciary breach.

In the case of plans in which the individual participants direct the investments, although participants can decide which of the offered investments to use, they cannot decide which investments are available to them; that is the job of the fiduciaries. Thus, in evaluating investments, the fiduciaries must select, monitor and dispose of investments for the exclusive purpose of providing retirement benefits. Their conduct in fulfilling this objective is measured under the prudent man standard.

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<sup>20</sup> Illinois Pension Code §109.1(4). The term “emerging investment managers” refers to MWBEs. Maryland law includes a similar “encouragement.” *See* Md. Code Ann., State Pers. & Pens. § 21-116.

<sup>21</sup> DOL Interpretive Bulletin 94-1

## The Prudent Man Standard of Care

The prudent man rule has several key elements:

- It requires fiduciaries to act with “care, skill, prudence, and diligence.”
- It requires them to do so in the context of the “circumstances then prevailing.”
- It requires that they do so in the same way that “a prudent person acting in a like capacity and familiar with these matters would use.”
- It requires that these steps be taken in connection with the “conduct of an enterprise of a like character and with like aims.”<sup>22</sup>

There are virtually no state regulations or cases that interpret the prudent man standard. However, in many states, the rule is substantially identical to that in ERISA. As a result, we are able to refer to DOL guidance and relevant case law interpreting ERISA for a further understanding of this rule.

The DOL has described the steps that a fiduciary must take in fulfilling the prudent man rule, with regard to investments, as follows:

“the requirements of the [prudent man rule] are satisfied if the fiduciary (A) has given appropriate consideration to those facts and circumstances that...the fiduciary knows or should know are relevant to the particular investment or investment course of action involved...and (B) has acted accordingly.”<sup>23</sup>

As indicated in the DOL regulation, fiduciaries need to determine what information is material and relevant to making a particular decision; they must gather that “relevant” information; they must examine and understand the information; and then they must make an informed and reasoned decision.<sup>24</sup>

In the context of investments, the fiduciaries must understand generally accepted investment principles and prevailing investment industry practices,<sup>25</sup> which form the “backbone” of a prudent process for investment decisions. Therefore, fiduciaries must engage in a process of determining and gathering the data relevant to make an informed decision and of evaluating that information to make a reasoned decision.

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<sup>22</sup> CA Const. Article XVI, §17(c)

<sup>23</sup> DOL Regulation Section 2550.404a-1(b)(1).

<sup>24</sup> See, e.g., DOL Reg. §2550.404a-1(b); 29 CFR 2550.404a-1(b).

<sup>25</sup> DOL Interpretive Bulletin 96-1



Below is a list of factors fiduciaries should consider in fulfilling their duty to engage in a prudent process for making decisions:

1. They must determine which “facts and circumstances” are relevant to making a decision on the issue (*e.g.*, the investments or services to be offered to participants). In the MWBE context, the information would include whether the managers of a proposed investment meet the MWBE definition in addition to the investment factors related to the investment.
2. The fiduciaries then must gather the relevant information. The collected information must include not only what they “know” is significant to the decision, but also what they “should know” is relevant. The “should know” requirement creates an obligation on the fiduciaries to either investigate the issues and facts themselves or to hire an experienced and knowledgeable advisor in order to fully understand the issues and to gather the information that is relevant to the decision.
3. The fiduciaries must then give “appropriate consideration” to the relevant information. That is, they must review and evaluate the relevant information in order to make a decision that is informed. As part of this process, they may engage experts to assist them in the analysis, but they must prudently select the experts and evaluate their advice; they may not rely “blindly” on their advisors. However, as a practical matter, if the advisors are well-qualified, then the fiduciaries may place great weight on their recommendations.
4. The fiduciaries must then reach a decision on the basis of the analysis they have undertaken and the assessment they have made of the information they have considered and the advice they have received. This is the essence of a “reasoned” decision.
5. Where the investment is intended to fulfill a social purpose, such as the objective of enhancing diversity in a plan’s investments, in order to decide to include the investment in plan, the fiduciaries must determine whether the MWBE-managed investment is equivalent to or superior to other investments of the same asset classes and objective.
6. Finally, the fiduciaries must implement that decision.

### **Selecting Investments**

The steps in this process are orderly and logical. The steps require two things: first, a diligent and disciplined approach to managing the plan; second, a level of expertise – expertise in selecting investments and services that will produce meaningful

retirement benefits. Where the rules require the collection and analysis of data, fiduciaries may substantially reduce that burden by working with competent advisors.

Again looking to the ERISA requirements related to investments, fiduciaries are required to use generally accepted investment principles, including modern portfolio theory, and prevailing practices within the investment community to establish a plan's investment policies and to select the investment options.<sup>26</sup> Stated more simply, this means taking steps to balance the risk associated with an investment against its expected return. Such a balance is generally achieved through strategic asset allocation – looking at an investment portfolio as a whole and taking into account diversification within the portfolio.

As discussed in more detail in Appendix C, the Nationwide Diversified Manager Fund (DMF) is designed to achieve this type of diversification. It is a balanced fund, which means that it includes both domestic and foreign equities, which are generally more volatile but are expected to obtain higher returns, and fixed income securities, which have a lower volatility but lower returns. The fund achieves this balance by using managers that specialize in these different types of investments. While satisfying the MWBE diversity objective, these managers have also been selected by Nationwide through a thorough screening process designed to obtain the highest quality investment management.

This fund is intended to meet key fiduciary objectives:

- First, the DMF is intended to achieve portfolio diversification. When offered in a participant-directed plan, this helps the participants by offering them an investment that balances potential return against risk. The participants are freed from having to assemble a balanced portfolio themselves from multiple investments.
- Second, the DMF is intended to assist fiduciaries in selecting a prudent investment that also meets the MWBE requirement. Fiduciaries are able to take comfort from the process used by Nationwide, a knowledgeable investment provider, in selecting the managers of the fund.

Appendix B considers state and local MWBE requirements.

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<sup>26</sup> *Id.*

## APPENDIX B DISCUSSION OF DIVERSITY REQUIREMENTS

State and local ethnic and gender diversity provisions generally fall into two categories:

- At the state level, a number of states have adopted provisions that “encourage” but do not mandate that plan investments be managed by minority-owned or women-owned businesses. This reflects a policy decision by the state legislatures that investment diversity is a worthy public objective.
- At the local level, many cities and counties have adopted more stringent requirements under which government contractors are required to make use of and pay a portion of the compensation under the contract to MWBEs. Failure to do so may result in the contractor not being selected to provide the service or to termination of the contract.

We discuss each of these below.

### **State Law Requirements**

To illustrate these requirements, we focus on Illinois and Maryland law. First, keep in mind that the state laws impose on government plan fiduciaries the exclusive purpose and prudent man standards discussed in Appendix A. But they go on to add an additional element not found in ERISA.

For example, in the Illinois Pension Code, the Legislature adopted the following statement of policy regarding the use of MWBEs to manage plan investments:

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.<sup>27</sup> [Emphasis added.]

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<sup>27</sup> Illinois Pension Code Section 1-109.

“Emerging investment managers” as used in this section refers broadly to minority-owned and women-owned businesses that meet certain criteria.<sup>28</sup> In essence, the Legislature is telling government plan fiduciaries that they should strongly consider engaging MWBEs to manage plan investments by “increas[ing] the racial, ethnic and gender diversity of its fiduciaries, *to the greatest extent feasible*” though within the bounds of prudence. [Emphasis added]

Maryland law is even more emphatic, though still within a framework of encouraging the use of MWBEs. The Maryland Pension Code provides as follows:<sup>29</sup>

“Use of minority business enterprises encouraged

(d)(1)(i) 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 Trustees, the Board of

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<sup>28</sup> Illinois Pension Code Section 1-109.1(4).

<sup>29</sup> Md. Code Ann., State Pers. & Pens. § 21-116. The section goes on to provide:

(ii) For purposes of this subsection, brokerage and investment management services shall include services relating to all allocated asset classes.

(2)(i) To assist it in achieving the goal described under paragraph (1) of this subsection, the Investment Committee shall undertake measures to remove any barriers that limit full participation by minority business enterprises in brokerage and investment management services opportunities afforded under this title.

(ii) The measures undertaken by the Investment Committee shall include the use of a wide variety of media, including the State Retirement Agency's website, to provide notice to a broad and varied range of potential providers about the brokerage and investment management services opportunities afforded by the State Retirement Agency.

(3) In consultation with the Governor's Office of Minority Affairs and the Investment Committee, the Board of Trustees shall develop guidelines to assist the Investment Committee in identifying and evaluating qualified minority business enterprises in order to help the State Retirement Agency achieve the objective for greater use of minority business enterprises for brokerage and investment management services.

(4) 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.”

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. [Emphasis added.]

While these statutes declare broad public policy designed to achieve diversity, and especially in Maryland, provide goals and objectives for achieving such a policy, in both statutes, the legislature makes it clear that the fiduciaries must not seek to achieve this goal at the expense of prudent investing. Under the Illinois statute, the fiduciaries are encouraged to meet the objective of diversity “within the bounds of financial and fiduciary prudence,” and in Maryland, fiduciaries are reminded that their decisions must be “consistent with [their] fiduciary duties.”

These reminders to the fiduciaries that they must not forget their duty to invest prudently appear to be consistent with a similar position taken by the DOL under ERISA. In 2008, the DOL considered whether the selection of “economically targeted investments” (or socially responsible investments), that is investments selected for the economic benefits they create or encourage apart from their investment return to the employee benefit plan, would be a prudent exercise of fiduciary discretion.<sup>30</sup> The DOL concluded that:

ERISA's plain text does not permit fiduciaries to make investment decisions on the basis of any factor other than the economic interest of the plan. Situations may arise, however, in which two or more investment alternatives are of equal economic value to a plan. The Department has recognized in past guidance that under these limited circumstances, fiduciaries can choose between the investment alternatives on the basis of a factor other than the economic interest of the plan. [However,] [g]iven the significance of ERISA's requirement that fiduciaries act ‘solely in the interest of participants and beneficiaries,’ the Department believes that, before selecting an economically targeted investment, fiduciaries must have first concluded that the alternative options are truly equal, taking into account a quantitative and qualitative analysis of the economic impact on the plan.

Stated more simply, the DOL concluded that while fiduciaries are not precluded from considering other factors (such as whether the investment is managed by MWBEs), those factors must not override the economic interests of the plan. If two investments are otherwise comparable and fit within the plan’s investment policy but one is managed by MWBEs and the other is not, it is acceptable to select the investment managed by the MWBE.

This conclusion is consistent with the statements contained in the Illinois and Maryland legislation, reminding fiduciaries that they must not lose sight of the economic interests of the plan and the participants in seeking to fulfill the diversity goal. While the state laws are certainly more emphatic in stressing the importance of achieving diversity

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<sup>30</sup> DOL Interpretive Bulletin 2008-1, 29 CFR Section 2509.08-1.

than the conclusion reached by the DOL, the Interpretive Bulletin should not be read as discouraging consideration of factors not specifically related to investment performance.

The DOL Interpretive Bulletin on economically targeted investments is only relevant to the extent it helps to provide some guidance to government plan fiduciaries regarding the exercise of the duty of prudence in the context of seeking ethnic and gender diversity. It is a reminder that the fiduciaries must keep the economic factors relevant to the investment clearly in mind even while they are seeking to fulfill the diversity goal.

## **Local Ordinances**

For purposes of this discussion, we focus on the ordinances of the City of Chicago and Cook County, Illinois. The Chicago ordinance specifies an “award goal” of at least 25% of the annual dollar value of contracts awarded by the City being paid to qualified minority-owned businesses and 5% to women-owned businesses:

The chief procurement officer shall establish a goal of awarding not less than 25 percent of the annual dollar value of all contracts to qualified M.B.E.s and five percent of the annual dollar value of all contracts to qualified W.B.E.'s.<sup>31</sup>

If a contractor fails to demonstrate that it is in compliance with this requirement, its contract can be terminated.<sup>32</sup>

To implement this goal, the chief procurement officer is instructed to take specific steps. The most critical is to:

Insert within specifications for each contract let through competitive bidding with an estimated value in excess of \$10,000.00 a requirement that the contractor commit to the expenditure of at least the M.B.E. percentage of the dollar value of the contract with one or more M.B.E.'s and at least the W.B.E. percentage of the dollar value with one or more W.B.E.'s. This commitment may be met by the contractor's status as M.B.E. or W.B.E., or by joint venture with one or more M.B.E.'s or W.B.E.'s as prime contractor (to the extent of the M.B.E. or W.B.E. participation in such joint venture), or by subcontracting a portion of the work to one or more M.B.E.'s or W.B.E.'s, or by purchase of materials or services for the work from one or more M.B.E.'s or W.B.E.'s, or by the indirect participation of M.B.E.'s or W.B.E.'s in other aspects of the contractor's business (but no dollar of such indirect M.B.E. or W.B.E. participation shall be credited more than once against a contractor's M.B.E. or W.B.E. commitment with respect to all contracts of such contractor), or by any combination of the foregoing.<sup>33</sup>

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<sup>31</sup> Chicago Municipal Code, Ch. 2-92-430.

<sup>32</sup> *Id.* at Ch. 2-92-440(e)(iii) and (iv).

<sup>33</sup> *Id.* at Ch. 2-92-440(a).

Contractors are given wide latitude in meeting the MWBE goal. The contractor itself may be a MWBE, it may subcontract with MWBEs, it may enter into a joint venture, it may purchase goods or services from MWBEs.

In the context of Plan investments, the goal can be achieved by also fulfilling the objective described in state law of selecting MWBEs to provide investment management services for the investments of a Plan. How this is achieved in the Nationwide Diverse Managers Fund is discussed in Appendix C.

**APPENDIX C**  
**DETAILED DESCRIPTION OF DIVERSE MANAGERS FUND AND MANAGER SELECTION PROCESS**

The information in this Appendix has been prepared by Nationwide Financial.

The Nationwide Diverse Managers Fund is a balanced fund that invests in domestic and international equities and fixed income securities, designed to provide a single fund that meets both income and growth objectives of plan fiduciaries or participants. The money managers of the Fund are minority and women-owned business enterprises.

Nationwide is committed to recruiting, developing and a diverse workforce and has received recognition from a number of ethnic and gender-focused groups. This focus on diversity has been extended to its suppliers, where Nationwide has sought out MWBE money managers with the experience and proven ability to bring value to plan participants.

The Fund was launched in March 2014 with a moderate investment style employing a growth strategy. The Fund’s target asset allocations are 50% to 70% in equities, primarily stocks, and at least 25% in fixed income, primarily bonds. At inception, the allocation was as follows:

<b>Asset Class</b>	<b>Percentage</b>	<b>Manager</b>
Fixed Income	40%	Garcia Hamilton & Associates
Equity	60%	
<ul style="list-style-type: none"> <li>▪ U.S. Stocks</li> <li>▪ International Stocks</li> <li>▪ Small Cap Stocks</li> </ul>	<ul style="list-style-type: none"> <li>▪ 32%</li> <li>▪ 15%</li> <li>▪ 13%</li> </ul>	<ul style="list-style-type: none"> <li>▪ Herndon Capital Management</li> <li>▪ Strategic Global Advisors</li> <li>▪ Ariel Investments</li> </ul>

The benchmark used to evaluate performance is the S&P 500 Index. Annual operating expenses of the Fund are 1.62%, though Nationwide as manager of the Fund has agreed to limit operating expenses to .84% through at least November 2015. There is one share class, the institutional service share class.

In selecting the managers for mutual funds and other investments that it offers, Nationwide has developed a multi-step manager selection process that begins with a quantitative analysis of all investment managers relative to their peer groups. It employs a number of statistics that show how a manager has performed historically and what



levels of risk were experienced to achieve those results. The next step is a qualitative review of each manager to learn more about the management firm's culture, stability, investment professionals and investment process. For step three, Nationwide works with its compliance team to conduct a thorough risk analysis, which looks at a firm's operational efficiency, financial stability, legal fund governance, portfolio construction and compliance practices. As a result, Nationwide is able to we get a multidimensional view of the opportunities and challenges it may see when working with a specific firm. The last step in the process is the ongoing practice of monitoring, in which the quantitative research, qualitative review and risk analysis is repeated, taking into account its expectations for that manager. This same process is employed in selecting diverse managers for the Diversified Managers Fund.<sup>34</sup>

Nationwide also takes steps to ensure that the money managers of the Fund have and retain their minority- or women-owned business entity status. Nationwide analysts assigned to monitor the sub-advisers utilize various third party applications that identify MWBEs. As an additional control, the analyst is required to confirm that the sub-adviser has been designated with minority ownership or women ownership status by a state authority. Lastly, a "change in ownership" clause is included in every investment advisory contract entered into with a sub-adviser. It stipulates that if the firm undergoes a change in ownership, the existing contract will be nullified. A new agreement must then be executed with the surviving entity, assuming that entity meets the initial selection criteria and (in the case of the Fund) MWBE status. If not, Nationwide engages in a search for a new MWBE sub-adviser.

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<sup>34</sup> For further information about this process, see the Nationwide Funds Group White Paper, "Investment Manager Selection Process" (2014).

## IMPORTANT DISCLOSURES

***Call 1-800-848-0920 to request a summary prospectus and/or a prospectus, or download prospectuses at [nationwide.com/mutualfunds](http://nationwide.com/mutualfunds). These prospectuses outline investment objectives, risks, fees, charges and expenses, and other information that you should read and consider carefully before investing.***

There is no assurance that the investment objective of any fund will be achieved. Investing in mutual funds involves risk, including the possible loss of principal. Share price, principal value, and return will vary, and you may have a gain or a loss when you sell your shares.

The Fund is subject to the risks of investing in equity securities (including micro-, small- and mid-cap companies), fixed-income securities and foreign securities, specifically in emerging markets. The Fund may invest in initial public offerings (IPOs) and special situation companies, which often are subject to greater and more unpredictable price changes than more-established stocks. A portion of the Fund utilizes a value style of investing and therefore may underperform other funds that use different investing styles. Please refer to the most recent prospectus for a more detailed explanation of the Fund's principal risks.

Each of the Fund's subadvisers makes investment decisions independently, and it is possible that the security selection process of one subadviser will not complement that of another subadviser. As a result, the Fund's exposure to a given security, industry sector or market capitalization could be smaller or larger than if the Fund were managed by a single subadviser, which could affect the Fund's performance.

Nationwide Funds Group (NFG) comprises Nationwide Fund Advisors, Nationwide Fund Distributors LLC and Nationwide Fund Management LLC. Together they provide advisory, distribution and administration services, respectively, to Nationwide Funds. Nationwide Fund Advisors (NFA) is the investment adviser to Nationwide Funds.

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