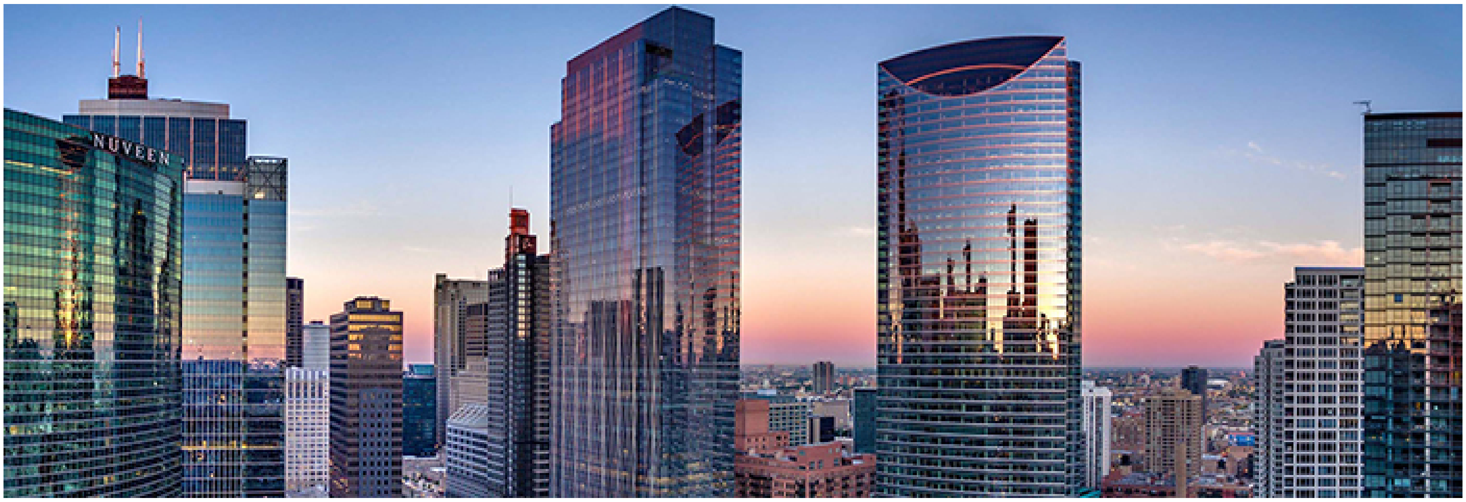

ISIA requires every Illinois "public agency" and "governmental unit" to implement ESG policies in their investments: action steps for private-sector actors

Investment Management Alert

2 March 2020

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ESG – that is, the consideration of environmental, social, and governance factors in choosing investments or operating businesses – has become a hot topic in the investment world. ESG comprises a broad category of factors ranging from environment sustainability to the protection of human rights in supply chains. But much of the focus has been on factors related specifically to environmental impacts contributing to climate change. Activist investors and some private investment managers have led a charge toward sustainable investment, and now governments are taking an interest in how ESG considerations affect the long-term value of their assets. This article addresses a recent notable development in Illinois, where a new state law makes ESG a key part of that state's investment decisions.

Allowing ESG factors to influence investment strategy is a big shift from the traditional paradigm that focuses primarily on shareholder value above most other considerations. But according to Goldman Sachs, "ESG and impact investing has moved into the mainstream, and we believe that now is the time to rethink how we talk about the field." Goldman has pledged to invest $150 billion in clean energy ventures by 2030. Blackrock has taken a similar interest in ESG polices, declaring an "increased commitment to integrate sustainability across its technology platform, risk management and investment strategies," including by exiting investments in industries like thermal coal. Blackrock's Davos brief noted that "[g]rowing interest in sustainability and a shift in society's preferences . . . could lead to a transformation in investor behavior—and a major, yet gradual, capital reallocation." And last year, Salesforce released a detailed report on ESG-related issues and committed to planting one trillion trees in the next decade.

Governments are a critical component of this ESG momentum. As institutional investors, their collective assets represent an enormous sum, and they are beginning to consider ESG as an important component of their investment policies. The European Union has been an ESG trailblazer. In October of 2019, the EU passed a law requiring financial servicers to disclose material sustainability issues with investments. The EU also requires benchmark-value administrators to consider ESG factors in determining investment value. In the US, state pension funds like CalPERS in California and the New York State Common Retirement Fund have voluntarily adopted rules requiring consideration of ESG factors in their investment decisions. Now, a state law in Illinois changes the landscape in the US and establishes Illinois as an early adopter of ESG legislation.

As of New Year's Day, the Illinois Sustainable Investing Act (ISIA) requires every Illinois "public agency" and "governmental unit" to "develop, publish, and implement sustainable investment policies applicable to the management of all public funds under its control." It also requires public agencies to consider "sustainability factors" in all aspects of their investment decisions when doing so is profitable, minimizes risk, and comports with their fiduciary duties. In so doing, the ISIA also amended the Deposit of State Moneys Act, the Public Funds Investment Act, and the Illinois Pension Code. The amendment to the Illinois Pension Code indicates that public agencies should make ESG investment decisions "within the bounds of financial and fiduciary prudence."

According to the Illinois State Treasurer, the ISIA means "all state and local government entities that hold and manage public funds should integrate material, relevant, and useful sustainability factors into their policies, processes, and decision-making." In theory, therefore, Illinois' different public investment funds each can have different policies. But in practice, many of these funds copied policies directly from the Illinois State Board of Investment's (ISBI) policy, which requires the ISBI to consider sustainability factors when making investments. Those factors include corporate governance, the environment, social and human capital, business models, and innovation. ISBI will continue to evaluate those factors in terms of their relevance to its overall portfolio and changes in the marketplace, and it will oversee its investment managers to ensure that these factors are considered. The ISBI has diversified its investments − over $19 billion at the end of 2019 − between different strategic partners and funds.

The ramifications here are vast. Americans invested $20 billion total in sustainable funds in 2019. If Illinois requires all $19 billion of its public investments to take sustainability into account, it would represent a dramatic increase in the value of investments guided by ESG considerations. If other states or the federal government were to follow suit, that trend will only intensify.

Sustainability has its limits, though. For example, ISIA-driven policies are not currently aimed at broad divestment from fossil fuels. The Office of the Treasurer's sustainability policy is much longer than some other agencies', but it specifically rejects divestment from securities "to achieve a goal that is not primarily investment related." It instead allows divestment only when "financial or reputational risks" implicate a fiduciary duty or profit incentive. This is in keeping with the amendment to the Illinois Pension Code, which limits decision making to the dictates of fiduciary duty or financial profit. Illinois is not alone: CalPERS has also rejected divestment. This is in line with the private sector's reluctance to engage in wholesale divestment motivated by ESG factors.

Most market observers expect this trend to continue incrementally, with ever more institutional actors, whether public or private, considering ESG factors when investing. While it may not satiate aggressive advocates of stronger and more immediate steps by the private sector to address climate change, this is a positive development for companies that focus on sustainability and that seek to attract this type of investment.

At least one thing is clear: with ESG surging into the mainstream, we can be sure that these recent developments will not be the last. Private-sector actors that seek out public institutional investment can do the following to prepare for these changes:

- Recognize the possibility of ESG-oriented regulation in other states and federally.
- Closely monitor emerging trends on ESG at the policy-making level.
- Consider ESG-related issues in presenting potential investments to institutional actors.
- Understand which disclosures are necessary to satisfy the relevant laws and regulations.

Learn more about this evolving trend by contacting any of the authors.

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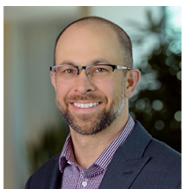

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