Impact at Scale

POLICY INNOVATION FOR INSTITUTIONAL INVESTMENT WITH SOCIAL AND ENVIRONMENTAL BENEFIT

INSIGHT AT PACIFIC COMMUNITY VENTURES
& THE INITIATIVE FOR RESPONSIBLE INVESTMENT
AT HARVARD UNIVERSITY

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About InSight at Pacific Community Ventures

InSight is the thought leadership and advisory practice at Pacific Community Ventures, a U.S. Community Development Financial Institution and nonprofit organization. InSight provides research on community development and impact investing to clients including The Rockefeller Foundation, Annie E. Casey Foundation and The California Endowment. InSight also evaluates the social and economic performance of more than $1 billion of targeted private equity investments by pension funds including the $230 billion California Public Employees Retirement System (CalPERS), investment managers including Hamilton Lane, and foundations including the Northwest Area Foundation, and $18 billion invested by CalPERS in California across asset classes. For more information on InSight's work see www.pacificcommunityventures.org/insight.

About the Initiative for Responsible Investment at Harvard University

The Initiative for Responsible Investment (IRI), a project of the Hauser Center for Nonprofit Organizations at Harvard University, promotes the development of the theory and practice of responsible investment through research, dialogue, and action. The IRI encourages the development of responsible investment theory and practice across asset classes, builds communities of practice around innovative responsible investment strategies, and catalyzes new opportunities and concepts in responsible investment. For more on the IRI's work see www.hausercenter.org/iri.

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PREFACE

Over the past few years, a growing number of investors have sought to deploy capital in investments designed to generate social and/or environmental benefit as well as provide a financial return. The sources and uses of this capital vary widely, as do the participants in this emerging impact investing industry. However, the largest pools of capital, namely institutional asset owners, are often absent from conversations among self-identified "impact investors." Institutional investors and the over $20 trillion in assets they control have the potential to play an important role in addressing the problems of our time.

Institutional investors are governed by rules and norms that can impede their participation in new or innovative investment vehicles; and institutional participation in impact investment markets is invariably tied to those public policies that shape and promote investment opportunities. Policy and regulation – while in and of themselves not a silver bullet – can play an important role in unlocking more institutional investment capital for greater social and environmental impact.

This report combines several elements that we believe must be part of a discussion about the role of public policy in unlocking institutional investment for impact. This includes an exploration and analysis of the unique opportunities and constraints faced by U.S. fiduciary investors, including relevant regulations. We also examine the different roles that policy can play in accelerating the development of impact investing practices and products. And finally – and most informatively – we offer insight and case studies about the current practices of institutional asset owners and service providers. In bringing these elements together, InSight and IRI have provided a framework for analysis that will stimulate important and productive dialogue among investors, policymakers, advocates, and other stakeholders. We look forward to your participation in that dialogue.

Margot Brandenburg, Associate Director, The Rockefeller Foundation
Justina Lai, Associate, The Rockefeller Foundation

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Errors and omissions are the responsibility of the authors alone.

ABOUT THIS RESEARCH

Impact at Scale is the second report published by the Global Impact Investing Policy Project (the Project), a partnership between InSight at Pacific Community Ventures and the Initiative for Responsible Investment at Harvard University, which is supported by The Rockefeller Foundation.

The Project was created in 2010 to clarify the role of public policy in impact investing and to help investors, public officials, advocates, researchers and related communities better identify and support policies that lead to more robust and effective capital markets with intentional social and environmental benefits.

The Project's first report, *Impact Investing: A Framework for Policy Design and Analysis (January 2011)*, presented a model for considering the appropriate role for government, the points in the market at which intervention is warranted, and the criteria likely to determine policy effectiveness. In this report, we apply that model to one specific group of investors: large institutional asset owners in the United States.

Project Development We researched and produced this report using an iterative strategy of market review, analysis and stakeholder engagement.

This strategy has included:

- Background research, including literature review and data gathering;
- In-depth, structured interviews with 35 institutional asset owners, investment management intermediaries and advisors;
- Informal discussions and stakeholder engagement with dozens of investors and related stakeholders throughout 2011; and
- Two workshops – the first with institutional asset owners at The Rockefeller Foundation in New York, June 2011, and the second with investment intermediaries and advisors at the Harvard Kennedy School, October 2011.

Objectives and Audience In this report, we offer a policy perspective on impact investing by institutional asset owners. We also demonstrate that where funds invest for intentional social and environmental benefit, the government often plays a key role as underwriter, co-investor, regulator, procurer of goods and services, or provider of subsidies and technical assistance. Because public policy is ubiquitous in investment markets, government has an essential role to play in catalyzing a broader and deeper deployment of institutional assets to opportunities with public benefits.

We have designed ***Impact at Scale*** for three primary audiences:

- **For public officials,** the report showcases policies that have already leveraged significant volumes of capital for impact investing; highlights the importance of market interventions that support and complement the fiduciary obligations of investors; and offers a framework for thinking about how policy is best designed to effectively mobilize institutional capital;
- **For investors,** the report provides insight into public sector priorities and perspectives to support greater mutual understanding and the development of constructive cross-sector partnerships; and
- **For advocates,** the report identifies areas of policy activity that hold promise for additional innovation; and offers a framework to engage with policymakers and investors on those issues where institutional capital can effectively serve public purpose.

Impact at Scale is not a roadmap. We do not attempt to make concrete policy recommendations and have intentionally presented findings and conclusions that provide thematic, not prescriptive, direction. The creation or reform of specific government interventions requires a level of analysis and issue-specific engagement beyond the scope of this work.

Our hope is the report provides thorough but practical insights into the approaches and activities of the public and private sectors in institutional impact investing. We wish to drive dialogue among public, private, and civil society sectors to prepare the way for appropriate and transparent policy innovation that significantly advances the interests of fund beneficiaries and public purpose.

NOTE: *In this report, we concentrate on more narrowly construed impact investment policies like support for geographically targeted economic development or more energy efficient real estate investments. We have chosen not to focus on systemic policy interventions, such as carbon pricing or a financial transactions tax, that advocates may believe would support more sustainable and socially beneficial market behavior. However, we encourage impact investing advocates, investors, policymakers, researchers, civil society groups and other stakeholders to integrate targeted discussion of impact investing policy with systemic analysis of the role of markets in society.*

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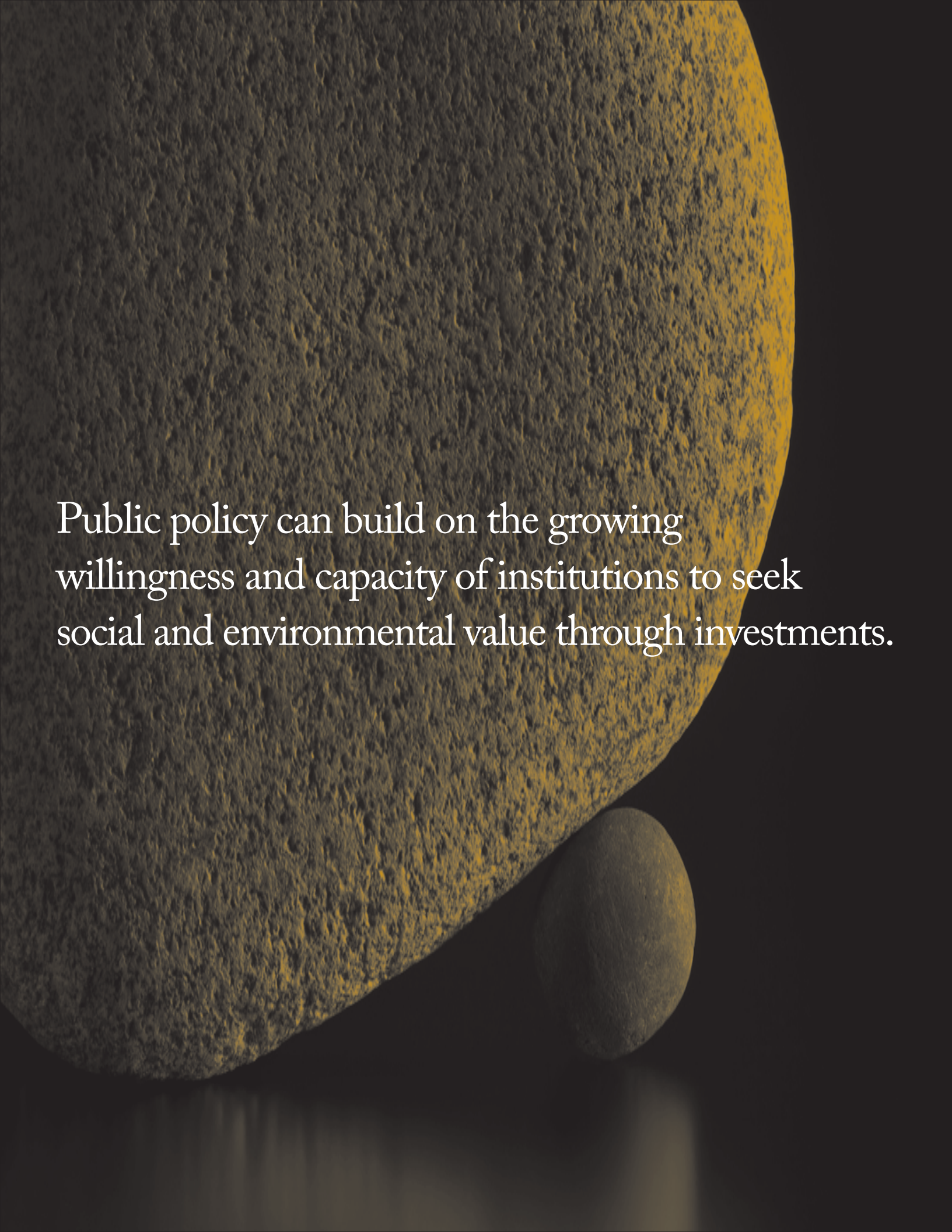


Public policy can build on the growing willingness and capacity of institutions to seek social and environmental value through investments.

1. EXECUTIVE SUMMARY

Impact Investment – investment with the intent to create measurable social or environmental benefit in addition to financial return - has received increasing attention in recent years. This includes interest from policymakers drawn by both the promise of leveraging private capital to support public purpose and the opportunity to make better use of scarce resources to support important social benefits.

Institutional Asset Owners – such as pension funds, endowments, and insurers – are an especially important category of current and prospective impact investor, even if they are not familiar or do not self-identify with the term "impact investing." With total assets of over $20 trillion, these anchor investors play a fundamental role in the domestic U.S. and world capital markets. For advocates of impact investing, engagement of institutional asset owners is one key to growing markets that create measurable social and environmental benefits. Institutional asset owners can also help legitimize the field for asset management intermediaries, consultants, lawyers, and other service providers.

But institutional asset owners face specific legal requirements and a distinct investment culture that often constrain their ability to invest with impact. These barriers must be taken into account for the institutional role in impact investing to grow beyond the current limited activity, and careful coordination between policymakers and institutional investors will be essential in building private investment markets that deliver positive social impact.

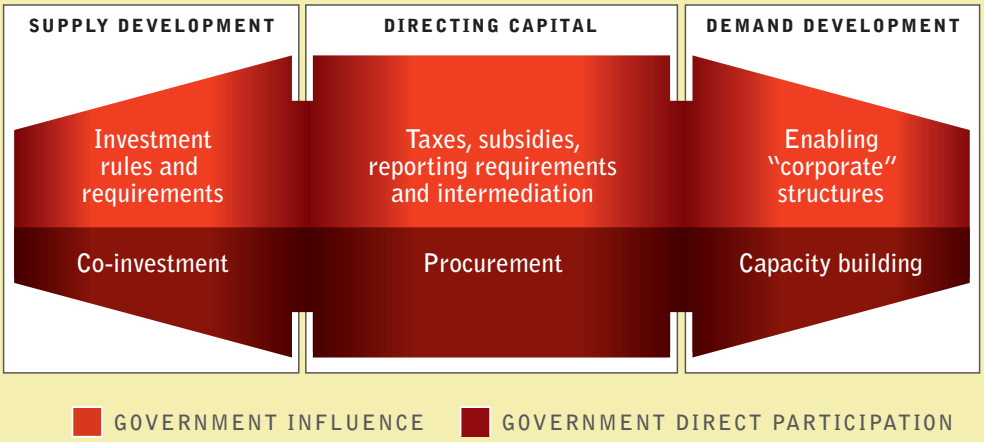
The Culture and Practice of Institutional Asset Owners

When making investments, institutional asset owners follow the conventions of fiduciary duty and portfolio management, as well as the institutional structures that design and implement investment strategies. Such conventions include diversified portfolios, standardized forms of investment that exist at scale, benchmarks that determine how the broader market evaluates products, and, especially in recent years, relatively short time horizons for evaluating investment performance.

In practice, institutional asset owners share a similar approach to impact investing, acknowledging that all investments – whether impact is a consideration or not – meet the legal requirements, due diligence processes, and standard asset class-specific benchmarks for expected financial risk and return. These investments are also typically consistent with the services and product offerings supplied to the institution by its third-party advisors.

Environmental and social targets are rarely acknowledged explicitly as part of the institutional investment framework. From the perspective of institutional asset owners, impact investing – as an emerging field of investments with occasionally unconventional goals or value propositions – may look idiosyncratic, too small, or too new.

POLICY FRAMEWORK



At the same time, an existing track record of institutional investment with explicit non-financial intent can offer policymakers a history on which to draw. Various terminologies are used to describe these activities, from "responsible investment" and "Environmental, Social, and Governance (ESG) integration" to "economically targeted investing."

We can point to two practices in particular that have shaped institutional investor participation in impact investing:

- Discrete targeting of ancillary social and environmental benefits within the context of investment products that otherwise resemble one another; and
- The incorporation of ESG analysis on the belief that long-term financial performance is linked to positive social and environmental performance that mitigates risk and identifies opportunities often not reflected in short-term investment analysis.
- The range of institutional investment practices that target economic development, underserved communities, job creation, and environmental sustainability – often driven by public policies – offers a substantial base on which to build impact investing policy engagement.

A Policy Lens on Institutional Impact Investment

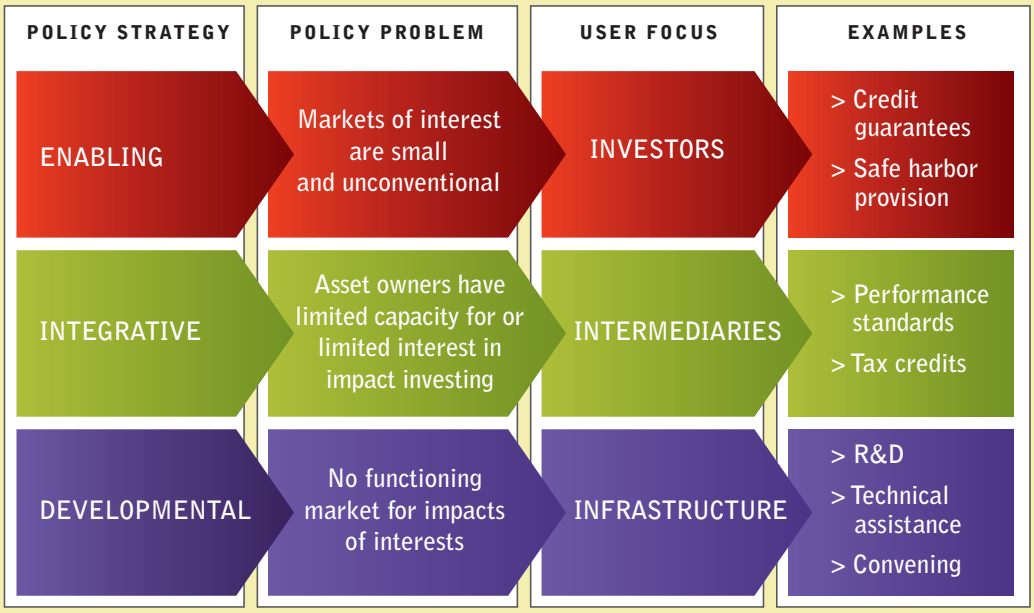
The public policy lens can provide a useful tool for examining institutional impact investing as the availability of capital from asset owners is closely tied to the public policy environment. For example, interpretations of fiduciary duty, defined by policy, can constrain investment by limiting real or perceived opportunities. But public policy can also encourage investment by supporting, for instance, tax credits that leverage private capital for investment in underserved communities or by creating investment opportunities that subsidize business enterprises delivering defined social benefits.

Our initial work on the role of government in impact investing, *Impact Investing: A Framework for Policy Design and Analysis*, described policy as intervening in three places: the supply of capital for impact investing; the demand for impact investing capital and availability of investment opportunities; and in directing existing capital toward investments with social benefit.

We can view these policies through a framework that identifies where government intervenes to shape investment outcomes.

- **ON THE SUPPLY SIDE,** policies can direct how institutional asset owners can or should invest capital, setting the regulatory framework that governs investment decisions. Policies may also create co-investment opportunities that lend government credibility and security to impact investment.
- Policies that **DIRECT CAPITAL** operate at the product or transaction level (i.e. at the "point of sale"), influencing markets primarily through incentives like tax credits and subsidies for industries and sectors that meet specific impact goals. Impact areas can include affordable housing, energy efficiency, transit-oriented development, urban or rural regeneration, health and wellness, and education. Other policies may mandate performance floors, like green building regulations or inclusionary zoning laws for affordable housing. Still others provide a related procurement preference. Policies that mandate transparency and reporting requirements are also included here.

MODEL FOR POLICY ENGAGEMENT



- **ON THE DEMAND SIDE,** policies can boost investment opportunities through the development of sound, investable companies, projects, and intermediaries. These policies can help develop or grow impact-related industries through technical assistance, pilot projects or other supporting efforts. They can make existing investment products more financially attractive through credit guarantees. Or they may help identify institutions that create social benefits through certification systems. These policies also help to communicate the existence and suitability of impact investing opportunities.

The policy lens can help public officials, advocates, investors and other stakeholders identify potential interventions that balance the needs of institutional asset owners – for scale, comparability, and comfort – while ensuring the delivery of social and environmental benefits.

A Model for Policy Engagement

Our research suggests that it may be useful to think of three key strategies for using policy to catalyze institutional impact investment:

1. **ENABLING:** By making impact markets investable, policy can help deliver the impact objectives institutional asset owners care most about. Enabling policies primarily address the challenge of small, untested, or unconventional markets where the impacts are of interest to institutions. These policies focus primarily on investors themselves and would establish guarantees to reduce risk in unconventional markets or fiduciary safe harbor provisions that assure investment decisions are legally defensible;

2. **INTEGRATIVE:** By adding an impact element to traditional markets, policy can expand the universe of impact nvestments suitable for institutional asset owners. Integrative policies primarily address the challenges of insufficient opportunities for investors to deploy capital for ancillary social and/or environmental benefit, and the lack of interest or capacity on the part of investors. Integrative policies target established intermediaries and would provide performance standards mandating social and environmental criteria, like green building standards, or tax credits to bolster the risk/return characteristics of investments; and

3. **DEVELOPMENTAL:** By developing market ideas and infrastructure, policy can build a pipeline of future impact investing opportunities for institutional asset owners. A developmental strategy is needed when markets are undeveloped or non-existent but impacts might be of interest moving forward. Developmental policies generally target the underlying infrastructure of nascent markets through support for research, technical assistance for prospective investees and their service providers, and convening key stakeholders to facilitate knowledge sharing.

As with all government interventions in impact investing, a balance must be struck between a policy's fidelity to an explicit public purpose and the risk that the intervention does more harm than good. To serve the public interest, government must ensure the policy is well targeted, transparent, and implemented efficiently at the appropriate scale and for the right duration.

Policies should also be designed not to reduce effective private investment or become subject to regulatory capture. In preparing to reform policy, government should ensure these questions are answered by engaging key stakeholders in the process and coordinating with other policies and agencies of interest.

Current practice and an evolving understanding of long-term value creation demonstrate a growing willingness and capacity on the part of institutional asset owners to seek social and environmental value through investments. Public policy can build on this practice to support institutional impact investing at scale.

2. INTRODUCTION

Large institutional asset owners including pension funds, endowments and insurers are one compelling group of investors who can help bring impact investing markets to scale. In this report, we look at public policy as a tool for helping policymakers, investors, civil society organizations, researchers and other stakeholders leverage institutional private investment for public good.

In discussing the relationship of impact investing, public policy, and institutional asset owners in the U.S., we highlight the following topics:

- The role that public policy plays in shaping institutional investment in impact investing;
- How policies can make impact investment opportunities investable and ensure existing investments have positive social or environmental benefits; and
- Opportunities for policy development to catalyze institutional asset owner interest and investment for social impact.

We hope to inform an approach to public policy development that matches the needs of institutional investors in the U.S. with the promise of impact investing to address crucial social needs. Supportive policies have been consistently identified as critical to the acceleration of the impact investing industry, including most recently in a 2011 survey of over 50 investing organizations by the Global Impact Investing Network and JP Morgan[1]. The finding comes in the wake of a number of influential research reports targeted to institutional investors and focused on the essential role of policy, particularly in environmental markets.[2]

Why U.S. Institutional Asset Owners?

We concentrate on institutional asset owners as a class of investors for several reasons:

- Large asset owners are potential sources for significant sums of investment capital and therefore might be seen as agents who can bring impact investing to scale in developing track records and deals.
- The entry of large asset owners into the impact investing market can, apart from their own investment, catalyze other investment by legitimizing the field for asset managers, service providers, and other investors.
- Institutional asset owners share legal requirements and a distinct investment culture that govern their service to beneficiaries.
- U.S. pension funds and endowments have a specific history with a variety of socially-and environmentally-oriented investment strategies from which the impact investment community can learn. These strategies fall under various labels such as responsible investment, mission investment, social investment, sustainable or green investment, or economically targeted investment.

We have chosen the additional geographic focus on U.S.-based institutional asset owners for the purposes of our policy analysis. While there are varying levels and types of policy that affects their participation – local, state, regional, national, and international – these asset owners are governed by a specific set of regulations most of which are specific to the U.S. context.

Operating within this context makes them distinct from other asset owners internationally and other investors domestically, though the lessons of engaging U.S. investors will apply to many areas around the globe.

In recent years, substantial attention has been devoted to the role that institutional investors should play in, for instance, shaping financial market responses to large scale environmental and social trends including climate change, resource scarcity, mass urbanization, demographic change, and wealth inequality. In this report, we hope to contribute to this discussion by paying particular attention to the role that institutional investors can play in investment strategies that specifically target outsized social and environmental performance that can be identified and measured.

The Institutional Investment Context: Challenges for Impact Investing Policies to Address

Institutional asset owners approach the investment and administration of their funds within the constraints of fiduciary duty, current interpretation of portfolio theory, and the complexities of executing investment strategy through third-party service providers. To understand how to engage this community through public policy, we have to understand the context in which they make their decisions.

Institutional investors are obligated by the standards of fiduciary duty to place the interests of fund beneficiaries – both present and future – above their own, and to consider only the interests of beneficiaries when making decisions. Whether or not they consider impact, they are still bound by these legal requirements and due diligence standards.

In practice this has led to the emergence of a set of conventional portfolio strategies and investment beliefs that lead to similar patterns of investing across institutional asset owners. Perhaps the most prominent intellectual current driving institutional asset owners is Modern Portfolio Theory, a set of assumptions about market efficiency and the correlation of financial performance among asset classes that has had profound implications for how investors allocate their resources

Modern Portfolio Theory (MPT), as currently implemented, evaluates investments on a limited number of factors, and has encouraged funds to benchmark the performance of fund portfolios with conventional, asset class-specific measures that compare investment risk and return. While benchmarks have become important tools for assessing performance, they may also cause conformity among a vast number of investors. Benchmarks have a tendency to favor standardized opportunities over innovative ones, and short-term investment performance over long-term sustainable wealth creation. To the extent that impact investments look too new, idiosyncratic, or niche, they may be disfavored by typical portfolio strategies.

A different barrier to impact investing emerges from the way that investment strategies are delegated. Most institutional asset owners manage their investments working in close concert with external investment advisors and intermediaries, while a smaller number of funds use internal staff. Whether managed internally or externally, asset owner trustees determine investment strategies, most often with the advice of investment consultants, and delegate the execution to staff or external service providers.

Delegation grants substantial control to staff, consultants, and fund managers over both the investment decisions that trustees make and the communication of those decisions to stakeholders. Agency issues involved in governing complex service provider relationships are vital to determining how investment performance is achieved, managed, and evaluated. To the extent that those incentives disfavor the consideration of social benefit, the asset owner institutional structure will hinder the uptake of impact investing.

Finally, there is the problem of scale. If the promise of institutional asset owners is bringing capital at scale to impact investing, it is also a challenge – investment opportunities must be of a sufficient size and structure to attract investor interest.

An Evolving Understanding of Fiduciary Duty and Portfolio Strategy: An Opportunity on Which Impact Investing Policy Can Build

A number of recent reports chronicle how the standards that govern institutional investment have evolved over time, and highlight that conceptions of fiduciary duty are not set in stone. Rather, changing realities and understandings of the world augment legal and conventional views of a trustee's fiduciary duty to beneficiaries. Indeed, the range of conventional investment strategies has itself changed dramatically over the years. Whereas in the past public equities were deemed too risky a product for institutional portfolios, now diversification into new asset classes and product types is the norm.

These changes highlight the opportunities for including impact investing in institutional practice. A growing body of research and investment practice focuses on the explicit integration of environmental and social issues into investment policies and strategies. Terms used to describe these activities include "responsible investment," "Environmental, Social, and Governance (ESG) integration" and "economically targeted investing".

Recent work on fiduciary duty and responsible investment has emphasized the importance of ESG factors in portfolios with long-term time horizons.[3] Issues such as climate change that pose substantial long-term risks are receiving special attention. For instance, the 2005 Freshfields report from the UN Environmental Programme Finance Initiative found that given existing regulations and case law, investors can take ESG considerations into account so long as they are "motivated by proper purposes and do not adversely affect the financial performance of the entire portfolio."[4] The report also highlighted that considering social and environmental impacts could be considered part of a diversification strategy.

Drawing from a related tradition, economically targeted investments, or ETIs, have a substantial history of participation by U.S. institutional asset owners. ETIs target financial return to the fund as well as economic growth or some other ancillary benefit in areas related to beneficiaries. They have traditionally targeted investment in underserved regions or communities, often on the argument that there are "emerging domestic markets" where investment opportunities can be linked to social benefits.[5]

As one example, in 2008 the Florida legislature passed a bill allowing 1.5 percent of the Florida Retirement System's $130 billion fund to be invested with in-state businesses in technology and other growth sectors. The state recognized that investments by the Florida pension fund in high growth areas had the potential to provide economic benefit to the state as well as offer market rate returns for the fund.

Institutional asset owners who consider ETI investments typically ensure that these opportunities match benchmarks on a risk-adjusted financial basis and are acceptable exclusively on their merits as financial investments, apart from any collateral benefits.

By preserving a focus on the due diligence process and by emphasizing the financial performance of investments, asset owners held to fiduciary duty standards have successfully integrated ESG and ETIs into their investment policies. Often driven by public policy, these practices offer a substantial base on which to build impact investing policy engagement.

In sum, this paper is designed to facilitate effective policy making that catalyzes impact investment from institutional asset owners. The sections that follow respond to these key points:

- Institutional asset owners offer the potential for capital at scale, though carefully crafted public policies are likely necessary to achieve this potential;
- To be successful, policy must take into account the rules and conventions that guide institutional investment practices; and
- There is a relatively robust body of practice on which impact investment policy can build.

We hope this paper helps frame productive conversations among policymakers, investors, researchers, and advocates, on how to successfully bring institutional capital to better serve public purpose.

The U.S. Market for Institutional Asset Owners

Institutional asset owners are the largest investors in the world, with over $20 trillion in funds under management. The group includes private and public pension funds, private and college endowments, and insurance companies. All of these investors are entrusted to invest capital on behalf of beneficiaries, whether they be current and future retirees, donors and the public more broadly, or current and prospective recipients of claims and annuities.

The breakdown of institutional assets in the U.S. is roughly as follows:

INVESTOR TYPE	ASSETS	SOURCE
Pension funds	$15.3 trillion	Towers Watson[6]
Insurance companies	$6.1 trillion	International Financial Services London[7]
College/university endowments	$400 billion	Responsible Endowments Coalition[8]
Private foundations	$590 billion	Foundation Center[9]
TOTAL	**$22.4 trillion**	

Though impact investments remain a relatively small component of the overall institutional market, there are numerous examples of asset owners that invest with explicit social benefit. Areas of focus mentioned in the policies of some asset owners include:

- Assisting the regional economy;
- Promoting economic wellbeing of the state, its localities, and its residents;
- Creating jobs and promoting economic opportunity;
- Providing capital in areas inadequately served by the market;
- Revitalizing neighborhoods; and
- Fostering environmental sustainability.

Those foundations that engage in mission or impact investing often have very specific social or environmental focuses, which are based on their institutionally defined mission.

3. A POLICY FRAMEWORK FOR INSTITUTIONAL IMPACT INVESTING

In the context of impact investing, we can think of public policies as a set of tools used to catalyze private investment in impact areas and to ensure this activity delivers the social benefits it promises. A variety of policies can help achieve these two goals.

For instance, policy can:

- Reinforce the validity of impact investing through interpretations of fiduciary duty;
- Set impact standards that private investors can target;
- Provide financial or reputational incentives for social benefit;
- Direct capital to invest with ancillary goals in mind;
- Set regulatory floors for acceptable social and environmental performance;
- Integrate performance standards in public investment and procurement policies;
- Provide support for the creation of new intermediaries and products;
- Create disclosure and transparency requirements on social impact issues; and
- Disseminate information on the social and financial performance of impact investments.

Successful public policies can channel capital toward investments with positive social impact, opening the door to engaged investors and increasing the impact of their investments. On the other hand, poorly designed or implemented policies may create barriers to investments with public benefit or reward investment activity that creates no additional or negative social outcomes.

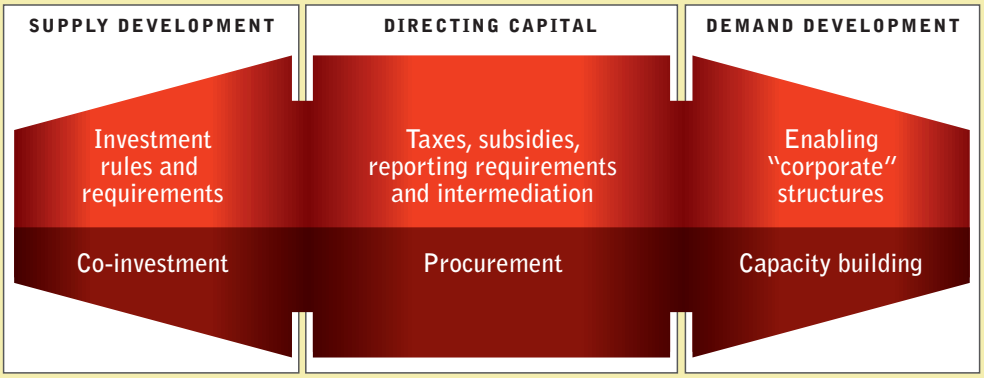
Though relatively few policies in the United States have addressed impact investing by name, different types of policies have promoted targeted investment. Several state-based economically targeted programs focus on job creation, infrastructure, or housing. Issue-based policies can mandate divestment from countries that policymakers find controversial, such as Sudan. Internal Revenue Service allowances for program-related investments by foundations allow for below-market investments that create social benefit to count toward a foundation's 5% annual required payout.[10]

Other policies have targeted asset managers. The Community Reinvestment Act, for example, targets banks and mandates investment in underserved areas where banks operate. The Low-Income Housing Tax Credit has opened the door to investment in affordable housing, helping to build a market for public benefit in real estate. Policies like Montana's Renewable Portfolio Standard help direct capital toward investments in renewable energy.[11]

In some cases, successful interventions involve multiple policies to catalyze impact investment in sectors deemed of particular public value. For example, the Healthy Food Financing Initiative – a joint project of the U.S. Departments of Agriculture, Treasury, and Health and Human Services – includes a $400 million mix of tax credits, below-market rate loans, loan guarantees, and grants (including technical assistance). This mix of interventions is intended to support and encourage investment in a range of community development financial institutions (CDFIs), nonprofits, and businesses that are working to address the absence of healthy foods, so called "food deserts," in American communities.[12] These interventions are paired with educational efforts for potential consumers that help shape the market for healthy foods.

By applying a policy lens to institutional investors in the U.S., we offer a framework for thinking about the most useful policy tools to engage this community. Our goal is to offer a relatively robust account of the range of policy interventions that may support impact investment. These polices run the gamut from the rules governing market activity, to direct government outlays that change the risk/return profiles of investments, to educational activities that reduce the transaction costs for finding and underwriting impact investment opportunities.

POLICY FRAMEWORK



Applying the Framework

The following sections lay out the framework for impact investing and public policy as they relate to the institutional asset owner community. The material is organized by supply side, directing capital, and demand side policies.

EXPANDING THE SUPPLY OF IMPACT INVESTING CAPITAL

Policies that affect the supply of capital available for impact investing fall into two general categories. The first category includes regulations that mandate how institutional asset owners

ERISA and the Department of Labor

Administrative rulemaking by government agencies can impact the willingness and manner by which institutional investors consider investments with ancillary impacts. To complicate matters, rules can change and evolve with changes in administrations. For example, the Employee Retirement Income Security Act (ERISA), enacted in 1974 and regulated by the U.S. Department of Labor (DoL), established standards of conduct for pension plan fiduciaries. The act legally required fiduciaries to manage these plans to maximize financial return "for the exclusive purpose of providing benefits to participants and their beneficiaries."[13]

Although ERISA did not explicitly prohibit plan managers from considering additional factors beyond financial return, many shied away from such investments for fear of violating their fiduciary duties. In 1994, the Department reinterpreted ERISA hoping to encourage more targeted investment by institutional investors. It ruled that selecting an ETI would not violate fiduciary duties as long as the investment provided the same rate of return at the same level of risk to comparable investments available to the plan.[14] Economically targeted and other impact investments by pension plans increased after this point.

However, a change in administrations and political orientation led to a re-reinterpretation of ERISA by the DoL in 2008 that established the so-called "rigid rule." This new rule narrowly interpreted ERISA, stating a fiduciary must only consider the economic interests of the plan when making investment decisions. Investments with a secondary purpose other than financial return could be considered only if they were "economically indistinguishable" from investments that satisfy primary obligations.[15] Anecdotal evidence from recent surveys suggests this reinterpretation of ERISA may have inhibited some plan managers from considering impact investments due to uncertainty around the standard.[16]

can or should invest capital; the second comprises co-investment opportunities in which public investment leverages private market participation.

SUPPLY DEVELOPMENT

POLICY TYPE	EXAMPLES
Rules and regulations	ERISA
Co-investment	Infrastructure Bank, SBA Impact Investment Fund

Rules and Regulations Governing the Investment of Institutional Assets

Rules and regulations that govern investments by institutional asset owners exist at a national and state level and vary by type of asset owner. These rules and regulations – both legislative and administrative – range from the vague to the specific, and they can change based on how they are interpreted, implemented, and overseen. They can mandate certain investment strategies, or, more generally, constrain or allow for the incorporation of ancillary social benefits into the investment decision-making process.

Policies related to fiduciary duty can play an important role in creating real or, just as important, perceived legal risk for engaging in impact investing. Therefore, interpretations of fiduciary duty are a common focus for institutional asset owners and the legal and investment advisors who work for them.

Certain laws and regulations, such as those in Nevada and Alaska, allow state pension funds to invest up to a certain percentage of assets in specific impact categories, such as for in-state economic development or other social and environmental goals. These new rules and regulations offer clear guidance for specific forms of impact investment, and they function for asset owners like Community Reinvestment Act legislation does for banks.

Even the prospect of regulation can help develop impact investing markets. In California and New York, for instance, the life insurance industry has developed the California Organized Investor Network and the Life Insurance Council of New York to promote community investment in lieu of legislation such as the CRA. In Massachusetts, the Life Initiative was formed by the insurance industry for similar purposes through negotiations with the state over the insurance industry's tax burdens.

Leveraging Federal Dollars – Invest Michigan! Mezzanine Fund

In 2011, the federal Small Business Administration (SBA) established a five-year, $1 billion Impact Investment Initiative, co-investing public funds with institutional investors to promote small business growth in underserved communities. This initiative is intended to bring together public resources with private capital and engaged fund managers to provide funding for place-based or sector-specific impact investments. The SBA is repurposing a segment of its long-standing Small Business Investment Company (SBIC) program to invest in and develop those funds that allocate at least half their investments to high-impact areas, such as low to moderate income communities, clean energy, and education.

In July 2011, the InvestMichigan! Mezzanine Fund became the first licensed fund under this initiative.[17] The SBA is co-investing with Michigan Growth Capital Partners, an investment partnership of the State of Michigan Retirement Systems, Dow Chemical, and InvestAmerica. The $130 million fund comprises $80 million from the SBA, $35 million from Michigan Growth Capital Partners, and an additional $15 million from Dow, which is headquartered in Michigan.

As its name suggests, the fund will provide $5 million to $15 million in mezzanine debt or equity to cash-flow-positive companies with $20 million or more in annual revenue. Qualifying companies must be headquartered in Michigan, have a significant presence in the state, or plan to expand or relocate there. Targeted investments may include industrial manufacturing, business services, health care, technology, and consumer products.[18] As of November 2011, the fund had made investments in a 14-year old information technology company and a 68-year old advanced manufacturing company, both based in Michigan.[19]

While certain regulations can help catalyze impact investing, many of these often have no clear mechanisms for enforcement. For instance, many state ETI mandates go unfulfilled with no penalty, limiting their effectiveness. Advocates must also consider whether new rules and regulations will create undue burdens that limit investment opportunities.

Appendix D includes a more detailed overview of the numerous policies that direct the capital of state pension funds to particular places where economic development is a priority for policymakers, as well as those which preclude such investments.

Co-investment

Co-investment opportunities, which involve investing private capital alongside public dollars, often take the shape of formal public-private partnerships, particularly at the scale necessary for institutional asset owner investment. By demonstrating government commitment, co-investment can reduce the real or perceived financial risk of the investment.

Government co-investment through a vehicle like an infrastructure bank can leverage private capital to expand available resources for creating public goods. The proposed National Infrastructure Bank would leverage $10 billion in public funding to attract long-term private capital for needed infrastructure investments in energy, transportation, and water at a 2:1 match. Proponents hope that the initiative will create quality jobs while developing necessary public infrastructure.[20] Another example is the Overseas Private Investment Corporation's (OPIC) recently launched impact investing financing initiative, which is providing $285 million to six impact investing funds in emerging markets. These investments will address impact areas such as job creation, health care, environmental protection and climate change, and are intended to leverage an additional $590 million in private investment.

Co-investments offer the potential for scale because public investment, like that of institutional asset owners, may favor big-ticket investments with longer time horizons.

However, many complications exist that can impede building well-crafted funds and deals. In addition, the potential for subsidizing unproductive activity or the perils of regulatory capture by private market participants are real investor concerns.

DIRECTING CAPITAL TO IMPACT INVESTMENTS

Policies that direct capital often function largely at the product level by affecting the terms or price of a transaction at the "point of sale". As the table below indicates, these policies may do anything from subsidizing specific outcomes to employing government procurement to shape markets. Impact areas that have seen policy development for directing capital include affordable housing, energy efficiency, transit-oriented development, urban or rural regeneration, health and wellness, and education.

DIRECTING CAPITAL

GOVERNMENT POLICY	EXAMPLES
Tax credits and subsidies	Low Income Housing Tax Credit, New Markets Tax Credit, Healthy Food Financing Initiative, Build America Bonds
Rules that set social performance floors	Montgomery County inclusionary zoning, SEC climate change reporting requirements
Procurement	General Services Administration Green Building Requirements
Information Provision: Research and Transparency	Portland State University reporting standards for the Economic Development Administration

Tax-Related Policies and Subsidies

Tax credits and other subsidies can create incentives for specified social outcomes, and they tend to focus on investment funds or deals in which institutional investors may participate. For example, the New Markets Tax Credits (NMTC) program gives individuals and corporate investors tax credits against their federal income tax return in exchange for making equity investments in certified operating businesses and real estate projects in low-income communities.[21] NMTC is a prominent component of many community investment real estate deals.

Tax credits help to make geographic markets, industries, or sectors more investable by changing the financial calculations that asset owners make. However, as tax credits involve direct government outlays – primarily through foregone tax revenue – they may be politically unstable, especially in times of economic hardship. This instability should be of particular concern for institutional asset owners who invest with long-term time horizons. The existing public funding cycle for renewable energy production, which requires frequent Congressional reauthorization, has discouraged asset owner participation in the market because of political risk.

At the same time, credits and other subsidies must be carefully targeted toward positive social impact, so as not to reward market activity that would be undertaken anyway or encourage rent-seeking among politically-connected intermediaries. Policymakers must develop mechanisms to monitor implementation and enforcement, as institutional asset owners are unlikely to perform this function.

Finally, from the perspective of institutional asset owners, tax credits are often by definition indirect paths toward leveraging capital. For institutional asset owners that are tax-exempt, tax credits hold little interest unless they can be used for leverage or risk mitigation in taxable deals or funds.

Solar Energy and the Business Energy Investment Tax Credit (ITC)

Several types of incentives are available for encouraging renewable energy production in the United States, ranging from corporate and residential tax credits, to subsidies and grants for installation, to lending and procurement standards. These policies exist at the local, state and federal level, and they have played an important role in spurring the growth of renewable energy industries in the U.S. by mandating or adjusting incentives for the use and development of renewable technologies. They often build on each other to create an ecosystem of policies that support the growth of nascent companies.

The Energy Policy Act of 2005 is one such policy that has incentivized the development of solar energy over other non-renewable sources. The Act created a federal investment tax credit (ITC) incentive for solar energy equal to 30% of expenditures on commercial and residential solar energy systems. Initially applicable for only two years, the tax credit was extended for an additional year with the Tax Relief and Health Care Act of 2006, and again for eight years in 2008 with the Emergency Economic Stabilization Act. This last version also allowed utilities to qualify for the tax credit. Between the creation of the ITC in 2006 and year-end 2010, U.S. solar manufacturing capacity quadrupled, with the vast majority of growth in 2009 and 2010. While not solely responsible for the market expansion, the ITC was a substantive driver and policy certainty provided by the eight-year extension has helped to catalyze private investment in the field.[22]

Expanding the Market for Fixed-Income Products: Build America Bonds

One approach to creating markets for institutional impact investing is to enhance the return of existing products so they meet institutional needs. The 2009 American Recovery and Reinvestment Act (ARRA) developed Build America Bonds (BABs), taxable bonds that aimed to catalyze investment in municipal projects to stimulate the economy and create jobs during the recession. The key provision in BABs was a federal subsidy paid to the issuing municipal or local authority equal to 35% of interest costs, which allowed state and local governments to offer an attractive interest rate to investors while reducing the cost of borrowing funds. The federal subsidy supporting BABs helped issuers develop bonds with a return higher than comparable tax-exempt bonds while lowering borrowing costs. This structure was able to attract institutional investors interested in the bonds' return as well as tax-exempt organizations such as pension funds and endowments that do not benefit from tax-exempt bonds. Over the two year span of the program, $181 billion of BABs securities were issued across the United States, saving state and local governments an estimated $20 billion in interest. While the program was successful in engaging the broader institutional investment market, it is less clear whether or not the BABs program contributed to the development of public purpose projects that would otherwise not have been executed.[23]

Rules that Set Social Benefit Performance Floors

Policies that build social benefit into conventional business operations create a de facto impact investing market in which institutional asset owners participate. These policies have the advantage of leveraging greater sums of capital than those more narrowly targeted to individual investor participation.

Such rules and regulations are often associated with issues like fair labor standards. The Davis-Bacon Act of 1931, for instance, mandates the payment of prevailing wages to workers on public projects. Critics may argue that the act creates barriers to investment by raising labor costs on infrastructure and other investment; on the other hand, to the extent that quality job creation is seen as a positive social impact, setting a prevailing wage floor can be seen as an impact investing policy.

Efforts that operate on similar principles include mandates by local communities that new and existing buildings meet minimum environmental performance standards or inclusionary zoning laws that require a certain percentage of affordable housing in multi-family residential development. These types of mandates can play a significant role in driving market behavior and catalyzing the development of businesses that respond to demand for impact investing products like affordable housing funds.

These examples highlight a set of significant issues with regard to institutional asset owners. Regulations that set performance floors are meant to shape markets so will depend on market participation. Policymakers will need to balance the private financial interests of investors against the potential public goods that performance floors can create.

San Francisco's Green Building Ordinance

The market for energy efficient buildings has seen a substantial increase over the last ten years thanks, in large part, to the development of the United States Green Building Council's (USGBC) Leadership in Energy Efficient Design (LEED) standards. Certification signals to prospective tenants and owners the building's superior environmental performance.

Over time, LEED standards have been incorporated into a number of municipal building regulations, significantly impacting the green building market. For instance, San Francisco's Green Building Ordinance will require major commercial buildings – defined as those over 25,000 square feet and 75 feet tall – to achieve the relatively high level of LEED Gold certification.[24]

These sorts of land use regulations play a similar role as incorporating environmental standards into procurement policies. A number of federal agencies have also adopted LEED standards in building and leasing guidelines. Among the most notable is the General Services Administration (GSA). The GSA is the largest civilian landlord in the U.S., and the incorporation of LEED standards into its procurement policies has sent an important market signal about the value of certification.[25]

Inclusionary Zoning in Montgomery County, Maryland

One of the most common examples of performance floors is in land use policies and the use of inclusionary zoning mandates to create affordable housing. Montgomery County, a large and affluent county in the Washington, D.C. metro area, implemented the first inclusionary zoning policy in the U.S. in 1974. Inclusionary zoning mandates or incentivizes the development of affordable housing alongside market-rate housing, thereby increasing the availability of residences for low income and working families.

Since 1974, Montgomery County's Moderately Priced Dwelling Unit (MPDU) policy has produced over 10,600 affordable housing units. To address the financial ramifications for developers, who are obligated to include affordable housing, the County set up a density bonus that allowed the developer to build more housing units on a specified plot of land than local zoning regulations usually allow. For developers, this bonus effectively subsidizes the fixed costs of development.

The additional involvement of low-income tax credits or tax-exempt bond financing in many of these projects has attracted institutional investors. Without MPDU, it is likely there would be fewer affordable housing units in Montgomery County and consequently fewer opportunities for institutional investors to invest in the sector.[26]

Information Provision: Research and Transparency Regulations

Government-sponsored research into impact investment can help clarify for investors where opportunities exist. Research on definitions, metrics for assessing impact, investment performance, and other information gathering efforts can help provide valuable background, crucial for this nascent field.

This type of research can help institutional asset owners overcome the process-related barriers when evaluating and selecting impact investments, especially for those investors who have not previously engaged in this area.

Rules that promote transparency of social impact performance by businesses can also help direct capital to impact investing by giving investors the information they need to incorporate ESG information into their decisions. Transparency has been a particular concern for the responsible investment community, which often advocates for efforts to improve social performance reporting standards for publicly traded companies.

Research, standard-setting, and transparency initiatives all must be carefully coordinated with investor needs and culture if they are to be effective. Information that cannot be adapted to investment strategies and decisions is unlikely to change investor behavior. Careful onsideration of the stakeholders who will use the information – asset owners, fund managers, consultants, policymakers, or community groups – is key to making these policies effective.

Security and Exchange Commission Climate Change Disclosure Requirements

In January 2010, the SEC released interpretive guidance for corporate reporting in the U.S., requiring public companies to take into account the impacts of climate change-related laws, regulations, and physical developments – such as rising sea levels – when determining what information to include, particularly as they relate to material risk. This new disclosure requirement changed not only the information available to investors who were concerned about climate change, but also the internal operations of publicly traded companies who were now required to consider the implication of climate risk, even if at a superficial reporting level.[27]

Public Procurement Standards

Purchasing by federal, state and local public agencies accounts for around ten percent of U.S. gross domestic product.[28] Incorporating social impact standards into procurement policies can use direct government investment to privilege products or services that create positive social impact.

Preferential purchasing, as such procurement policies are often termed, has been used successfully for decades to support women and minority-owned enterprises, driving business to them and increasing their need for growth capital. These policies can also promote green purchasing in areas like real estate, energy efficiency, waste, and clean energy. They have also been used to target specific geographies, a direct government investment counterpart to economically targeted investments from pension funds.

Procurement policies can be difficult to design and reform, however. They involve complicated operational processes, significant entrenched supplier relationships and interests, and a purchasing culture that may prioritize short-term economic considerations and cost competitiveness over long-term impact.

Procurement as a Market Development Tool: U.S. Army and Renewable Energy

The U.S. military has been a major force behind the commercialization of products, such as the Internet and GPS systems, which had clear initial military purposes but expanded public uses. Recent policy initiatives around renewable energy – for energy security, safety of military personnel, and military efficiency reasons – suggest that the market for clean energy may also be spurred on by military procurement.

The 2007 National Defense Authorization Act requires that 25% of the Department of Defense's total electricity usage come from renewable energy sources by 2025. To meet this requirement, the U.S. Army created an Energy Initiatives Task Force in August 2011 to collaborate with the private sector to invest in large-scale renewable energy projects on Army land. The Army will lease land to private developers to build renewable energy installations, and will provide stable demand for the electricity by entering into 20- to 30-year power purchase agreements.

To meet its 2025 targets, the Army estimates that it will need to generate 2.1 million megawatt-hours of clean power annually, which will require $7.1 billion in private investment.[29]

BUILDING DEMAND FOR IMPACT INVESTMENT BY INSTITUTIONAL INVESTORS

Just as public policies can build the supply of capital from institutional asset owners for impact investing, they can also increase demand from investees for institutional capital. Policies can also help develop or scale an industry's subsectors or practices that have positive impact through a number of mechanisms: developing technical assistance and pilot projects; making existing products more financially attractive through credit guarantees; or identifying and building reputational value for organizations that create social benefits through certification systems or educational initiatives.

Demand development can involve longer-term efforts to grow investment opportunities, with the attraction of institutional capital as a final outcome of the process. But during this process, publicly sponsored educational programs can highlight the ideas and practice of impact investing currently underway to unfamiliar audiences, including institutional investors.

Demand development policies assist in the creation of impact investment products suitable for institutional asset owners and help communicate their existence and suitability.

DEMAND DEVELOPMENT

GOVERNMENT POLICY	EXAMPLES
Certification and education	White House, Department of State, Small Business Administration, Environmental Protection Agency, and Economic Development Agency programs; Energy Star Certification
Capacity-building and technical assistance	Community Development Financial Institutions Fund technical assistance grants
Credit guarantees and enhancements	Department of Energy credit enhancements

In newer industries, policies pertaining to grant funding, technical assistance, or pilot programs can help businesses and funds scale to a level that makes them ready to accept institutional investor capital. Educational and communications efforts, such as those undertaken by the recently created White House Office of Social Innovation, help familiarize institutional asset owners with investment opportunities. We describe these various demand development activities in the following sections.

Certification and Educational Programs

Certification programs like Energy Star can build consumer demand for energy efficient products, from appliances to buildings, in a way that creates demand for green investment strategy that can lead to institutional investment. Certification as a Community Development Financial Institution offers an easy rule of thumb for mission driven investors to target investment intermediaries with credible positive social impact, for instance.

Impact investing as a general topic, as well as specific impact investing sectors, have seen recent attention from a variety of governmental organizations. The Community Affairs Divisions of the Federal Reserve Board's regional offices have taken on specific sectors – community investment, affordable housing, health, rural investment, and green buildings, among others – in ways that have connected policymakers, investors, researchers, and other advocates. These programs help cultivate a favorable climate for impact investing, and can serve as a point of entry for institutional asset owners who have yet to be exposed to the field.

Building Assessment Tools through Federal Grants – Portland State and the EDA

The government can promote impact investing by supporting the development of tools that allow investors, stakeholders, and policymakers to better design and determine the impact of economic development efforts. In 2010, the U.S. Commerce Department's Economic Development Administration (EDA) provided a $495,000 grant to Portland State University in Oregon to develop a methodology and online tool to enable practitioners and policymakers to fully assess the impact of economic development investments across financial, social, and environmental criteria.

These triple bottom line metrics developed by Portland State, which will include traditional economic metrics as well as social and environmental metrics, will be used by the EDA to assess their policymaking efforts. Portland State will also make the tool publicly available online to help assess, develop, and communicate a project's or investment's triple bottom line. A beta version, due to launch in March 2012, will be available for application to public, private, and nonprofit projects.[30]

Credit Guarantees

Credit guarantees and enhancements from the government help to mitigate investor risk by ensuring a certain rate of return or by taking first loss positions. Credit enhancements can also mitigate concerns of newness or idiosyncrasy that some investors may have of certain impact investment products.

Policies that target areas of investment which conventional market activity may disfavor – these include programs such as SBA loan guarantees for small business development, USDA loan guarantees for rural community facilities development, and HHS guarantees for health-care facility construction. These three policies have all been used in conjunction with New Markets Tax Credits projects to incent private investment.

Green bonds, like those issued by the World Bank, offer investors bonds that carry the World Bank credit rating and target alternative energy production and energy efficiency strategies in infrastructure and real estate investment. Institutional asset owners in the U.S., including the State of California, have invested in these green bonds as part of their broader climate strategies, and they offer useful lessons for policymakers.

Municipal Debt and the New York City Financial Crisis

In response to New York City's financial crisis in 1975, Felix Rohatyn, a well-connected banker at Lazard Frères, engineered a solution to the city's potential debt default that serves as a useful paradigm of targeted investing. Mr. Rohatyn struck a deal among public officials, unions, and pension funds allowing the city to issue debt to meet its immediate cash flow needs. Pension funds purchased these bonds, in effect using their investment strategies to resuscitate the stumbling city economy. From the pension funds' perspective, the key to the deal was a public guarantee for the debt issued by the federal government.

This extreme case highlights some important implications for engaging institutional investors. The funds here had clear interest, in the service of their beneficiaries, in helping to stabilize the financial environment that determined how they and their beneficiaries would thrive over time. Even so, the public policy intervention, which provided a guarantee for the debt, was necessary to make the deal work. Pension funds, despite their obvious interest, could not shoulder the uncertainty of the debt issuance alone given the volatile market conditions for municipal debt at the time.[31]

Technical Assistance

Technical assistance policies expand the capacities and effectiveness of investees to do their work at scale. This assistance can take the form of financial support for pilot projects, grants to support product development or subsidize expansion, and other support such as advising, networking, or providing information.

From the asset owner's perspective, these policies increase the appeal and variety of impact investment options, and they potentially help to refine impact opportunities.

Our review of policies that can engage institutional asset owners in impact investing reveals a wide range of potential policy interventions. We hope this review offers policymakers and advocates a better frame to determine what policies to design, how policies need to be coordinated with each other, and where in the investment ecosystem policies can best lay the groundwork for institutional asset owner investment to achieve positive social impact.

For these tools to be effective, policies must be carefully designed by government to meet the needs of institutional asset owners and create self-reinforcing mechanisms for evaluation and oversight of social impact. The policy framework for institutional impact investing, in other words, is itself a tool that can inform successful strategies allowing asset owners to successfully participate in this growing market.

The CDFI Fund and Capacity – Building for Community Investment

Since 1994, the Community Development Financial Institutions (CDFI) Fund, a program of the U.S. Department of the Treasury, has offered Technical Assistance (TA) grants to help community development financial institutions build the skills and capabilities to better serve their communities.[32] With these grants, the government hopes to build a more robust impact marketplace through the development of CDFI intermediaries and, in turn, attract more capital from investors for community-based projects.

During its 2011 program year, the CDFI Fund awarded some $3.1 million in TA grants to 37 CDFIs spread across rural and urban areas, including 31 loan funds, five credit unions, and a venture capital fund. The maximum TA grant was $100,000, with the average about $85,000. Recipients allocated much of the grant money toward operational expenses such as salaries, professional and consulting services, staff training, and equipment purchases that are essential for organizational growth.[33]

CDFIs are the anchor intermediaries for a number of institutional asset owners interested in the ancillary community development benefits of the investments they make. The General Board of Pension and Health Benefits of the United Methodist Church, for instance, has invested over $775 million since 1990 in affordable housing, community development, and expanded loan opportunities for poor communities through its Positive Social Purpose Lending Program.[34]

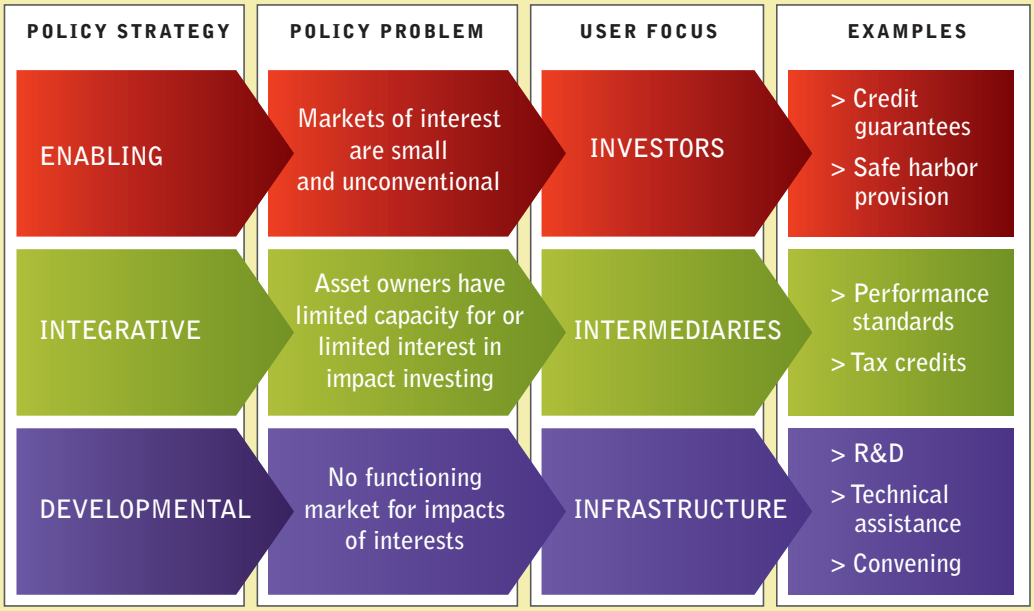
4. MAKING POLICY WORK: A STRATEGY FOR TARGETED ENGAGEMENT

Institutional asset owners have the potential, through their investments, for delivering social and environmental impacts at scale. But for public policy to help achieve this goal, it must take into account the nature of asset owners as investors and, in the near term, overcome perceptions of impact investing as a new, idiosyncratic, or niche market.

The supply, demand, and directional approaches outlined above are useful tools for locating and understanding the role of government in targeted investment markets. The framework can be applied across stakeholder groups, issue areas (like affordable housing or business finance in underserved markets), or geographies to better analyze the interplay of a broad range of policies and their effects.

The benefit of focusing on one class of practitioners in this research – institutional asset owners that sit squarely on the supply side of the continuum – is that it reveals more concrete strategies for investor engagement. These strategies focus policy on the specific challenges government can address for institutional asset owners and bring an important "user-oriented" perspective.

MODEL FOR POLICY ENGAGEMENT



Specifically, policymakers are faced with three overarching challenges when seeking to grow the activity of institutional asset owners in impact investing:

1. Impact investment markets that are of interest to institutional asset owners may be unfamiliar, small, or unconventional in design;
2. Most asset owners invest primarily through intermediaries – the asset owners themselves have limited control over the design of products and limited capacity to target impact; the intermediaries in whom they invest may themselves be skeptical or unlikely to pursue non-financial objectives; and
3. Impact investing market infrastructure is underdeveloped, leaving fewer opportunities for investment.

Policies that respond to each of these challenges often share a similar user or target group:

- **INVESTORS:** where an "enabling" strategy is needed to provide flexibility and investability in target markets;
- **INTERMEDIARIES:** where an "integrative" strategy can be used to deliver impacts through traditional markets that achieve public purposes regardless of investor motivations; and
- **INFRASTRUCTURE (and market development more generally):** where a "developmental" strategy can be used to support nascent markets.

We discuss these user groups in the sections below.

The Enabling Strategy: A Focus on Investors

In the U.S., a critical mass of institutional asset owners exists who are interested in taking up impact investing or are actively integrating ESG analysis into their strategies in ways that may lead them to impact investing. But they may report a number of barriers to turning theory into practice in the form of concrete impact investments. In interviews, they describe impact investments as unconventional, new, small, or policy dependent, all of which may increase perceived risk.

Policymakers can target such investors directly by implementing policies that reduce real or perceived risks or by providing asset owners with additional legal flexibility to make impact investments more investable.

Such policies might include:

- **Clear federal legal interpretations of fiduciary duty** or safe harbor laws that confirm that impact investments, and the consideration of social and environmental benefits, are not barred by fiduciary duty. Such policies might reduce uncertainty for investors who occasionally report concern about fiduciary barriers to impact investing.
- **State laws that allow for economically or environmentally targeted investment** from public pension funds. Policymaking at the state and local level – where government best understands the close fit between social and environmental impacts and the best interests of fund beneficiaries – can open the door for institutional investors to consider double- or triple-bottom line investments in underserved areas and communities. These policies have played important roles in catalyzing specific impact investing markets.
- **Loan guarantees** from all levels of government that reduce risk for new or unfamiliar products. These guarantees can catalyze the development of innovative markets, alternative energy production, or affordable housing.
- **Aggregation of smaller investments** in markets, such as small business lending or energy efficiency investments, that are seen to have positive social impact but do not reach the scale of investments needed by larger asset owners.

The fundamental principle here is that the right policies can help shape idiosyncratic investments to match more closely the sorts of markets that institutional asset owners are already equipped to evaluate.

Because the focus in this strategy is on the investor, the policymaker has an obligation to understand whether the impacts in question serve a public purpose and what can reasonably and efficiently be done to address specific investor concerns. Demand for policy innovation in this area is likely to originate from institutional asset owners and their direct beneficiaries, as it has in states where labor and business groups have successfully advocated for ETI policies.

The Integrative Strategy: A Focus on Intermediaries

Many institutional asset owners report a relatively limited set of impact options that meet their investment criteria. In any case, they may be skeptical of investments with social objectives, or they may have little interest or capacity to adopt impact investment strategies.

Policymakers can address this problem by identifying ways in which policies can build social impact into conventional investment vehicles. This approach can make the asset owners' intentions less relevant to the process of impact investing by making the social outcome something of a fait accompli.

In this strategy, established intermediaries are the focus because they play the critical role in bringing conventional investment opportunities to institutional asset owners. They will continue to do so until new, more impact-oriented intermediaries become "institutional quality" with the requisite years of experience and performance track record.

For institutions with an interest in impact investing, an integrated strategy will expand the universe of investments with which to accomplish their objectives. For institutions with no interest in impact investing, the investments they are already making can be leveraged by government to achieve public purposes.

Such policies might include:

- **Mandating certain levels of social performance,** for instance setting floors for labor or environmental standards. These policies raise the positive social impact of whole sub-markets in which asset owners participate.
- **Directing capital from intermediaries toward impact investing** as part of their license to operate. The Community Reinvestment Act, whose provisions mandate targeted investment by banks in underserved communities, has played an overwhelmingly important role in the creation of the U.S. community investment industry and helped shape other forms of asset owner participation.
- **Subsidizing positive social impact through tax credits,** which may capture asset owner investment in ways that create positive social impact via their intermediaries. This approach can create investable funds or deals leveraging public investment in social goods like affordable housing, investment in low income areas, land conservation easements, energy efficiency, and historical building preservation.
- **Targeting mission-driven investors** who can absorb risk or agree to lower returns in funds or deals as a way to leverage institutional investment. Public policies, such as the special IRS designation of program-related investments used by foundations, can lay the groundwork for larger institutions to invest in impact investments.

In this strategy, policymakers must understand if a public purpose should be addressed through established capital markets (and established intermediaries) and, if so, in what manner a policy intervention might ensure maximum impact.

For these indirect strategies, policymakers must be careful to observe how such policies do or do not offer a clear path for institutional asset owner participation. The threat of regulatory capture, through support for less effective mechanisms that generate fees for intermediaries, is of special concern here.

CRITERIA FOR EVALUATING IMPACT INVESTING POLICY

In our previous report, we distinguished six criteria for assessing the value of impact investing policy that may be useful to policymakers, investors, and other stakeholders. Restated with the goal of catalyzing capital from institutional asset owners, these criteria are:

TARGETING

The focus of a policy must be carefully matched to its objectives. The more closely a policy fits the asset owner's beneficiaries or stated mission, the more likely it is to enable institutional impact investments.

TRANSPARENCY

Transparency in the substance and mechanism of policy is important for investors. Asset owners should favor clear investment and fee structures, reliable information on positive social impact, and a means to compare particular strategies or investments to impact investing as well as conventional peer groups.

COORDINATION

A policy is likely to be more effective if it works in coordination with existing policies and markets to leverage their effectiveness. These types of policies, which are designed to catalyze private investment, can leverage institutional asset owners without targeting them directly.

ENGAGEMENT

Engagement with asset owners is important to clarify their needs. Institutional asset owners are meant to be conservative, and they may be skeptical about the relatively new field of impact investing. Coordinating with investors as policies are developed can help reduce skepticism and facilitate uptake.

COMMITMENT

Commitment to a policy should be consistent with the need. Institutional asset owners are typically long-term investors, and should favor policies that enable long-term sustainable returns.

IMPLEMENTATION

An institutional context and infrastructure that supports efficient implementation and modification of enacted policies is critical to success. Institutional investors are unlikely to be the first investors in new or less understood products, and are likely to scrutinize the policy environment as closely as investment performance when evaluating impact investment opportunities.

The Developmental Strategy: A Focus on Market Infrastructure

Beyond specific efforts to make impact investments investable, or to build social impact into investment markets, are policies that lay the groundwork for successful institutional investor engagement. Public policies can support a more robust market infrastructure in a number of ways to catalyze asset owner participation in impact investment.

By forging new relationships, creating additional data and evidence, supporting the development of products and platforms, and providing assistance to new intermediaries and other service providers, government can benefit institutional asset owners by building a pipeline of future, investable impact markets.

Such policies might include:

- **Supporting high impact enterprises.** Technical assistance for small businesses in underserved communities is a prototypical example of policies that can help prepare high impact enterprises to receive and leverage institutional capital.
- **Incorporating social impact into public investment and purchasing strategies.** This might mean incorporating labor or environmental standards into public procurement policies and the establishment of public-private partnerships. This form of direct public investment can build an impactful marketplace that extends to asset owners.
- **Developing standards and support for systems of measurement.** Though private investment may not be targeted in a particular case, establishing social impact criteria and measurements can play an important role in bringing standards and rigor to impact investment. Interagency collaborations like the Sustainable Communities Initiative – a joint program of the Department of Housing and Urban Development, the U.S. Environmental Protection Agency, and the U.S. Department of Transportation – may play an important role in setting performance standards that will ideally inform better coordination of public investment in infrastructure, transit, and housing. Along a similar line, policies that recognize and support high impact organizations such as B-Corporations can help normalize a vision for high social performance in the private sector.
- **Promoting the concept of impact investing.** By calling attention to successful examples of private investment for public purpose, and to the public policies that supported these efforts, government can contribute to the development and dissemination of data in the field. One common complaint is about the complexity of deals that create positive social impact, especially in discovering and accessing multiple sources of public and private capital. Policy could support clearinghouses that reduce the transaction costs associated with locating subsidies and other forms of public investment.
- **Convening multiple stakeholders.** By bringing together public, private, and nonprofit stakeholders around specific social issues that could be addressed through private investment, government can bridge knowledge and cultural gaps and develop critical institutional relationships. For example, The Federal Reserve Bank of Boston has been collaborating with the Financial Innovations Roundtable at the University of New Hampshire on a series of initiatives and research activities around community development finance and the barriers to addressing financial needs in low income communities.[35]

Developing the market for impact investment is a strategy that is likely to require some time to fully engage private market investors. Without such a strategy, however, policies that make impact markets investable or that build impact into particular investments will be harder to design, implement, and maintain.

With developmental strategies, policymakers must determine where there is potential for market growth and whether longer-term investment in market infrastructure is likely to deliver public benefits through investment activity.

5. CONCLUSION

We have focused this research on the potential ways in which public policy might help mobilize institutional asset owners in the U.S. to make impact investments. To do this, we specifically apply the general principles outlined in our previous report – ***Impact Investing: A Framework for Policy Design and Analysis*** – to a set of investors with the potential to bring scale and credibility to the field.

In conclusion, we recommend policymakers and advocates keep several points in mind as they engage asset owners around impact investing.

- Institutional asset owners have a set of shared characteristics – from overlapping fiduciary duties to an investment culture shaped by portfolio strategies and service providers – that should be considered when making effective policy. To understand how to mobilize institutional capital, policies should account for issues like fiduciary duty, the prevalence of asset class benchmarking, and the delegation of investment strategies to consultants and fund managers.
- A number of institutional asset owners already engage in impact investments, but often by other names such as responsible investment or economically targeted investment. The impact investment community can build on this history and these practices.
- As a starting point for policy development, policymakers might focus on the social and environmental impacts institutional asset owners and their beneficiaries already care most about. If these impacts serve a public purpose and can be realized in capital markets, a strong case can be made for policy that addresses the legal and market barriers that suppress this activity.
- Applying the policy framework to U.S. institutional investors reveals a breadth of activity in investing for social and environmental benefit and a potentially expansive approach to engagement strategies and policy tools for government to build more robust and sustainable impact investing markets.
- To most effectively engage institutional asset owners, policymakers should consider the various points of leverage they have in the investment ecosystem. Targeting policies to asset owners themselves can support engaged institutions; building social impact into intermediaries expands the range of investments that create social impact; and developing market infrastructure for impact investing can help make both investors and fund managers more capable of entering the market.

6. APPENDICES

APPENDIX A: INSTITUTIONAL INVESTOR CONTEXT

Understanding how institutional asset owners approach their investment decisions – considering both real and perceived obstacles – is important for developing appropriate strategies for engagement on impact investing, particularly in policy discussions.

Here we review the legal environment and current interpretations of fiduciary duty, and draw a general picture of the conventional investment methods of institutions and their relationship to third-party service providers.

Institutional asset owners are, by definition, entrusted to manage funds on behalf of their beneficiaries including: public and private pension funds and plan sponsors responsible for supporting current and future retirees; insurance companies for obligations to their policyholders; and endowments for the purposes specified by donors.

Due to their special relationship to beneficiaries and the potential for self-dealing and conflicts of interest, institutional investors are bound by law to the highest standard of care in their investment and administration of funds.

The concept binds together a set of "standards of care" that make up fiduciary duty. Relevant here are the duties of:

- **Care:** Fiduciaries are required to subordinate their own interests to those of the beneficiaries of their fund;
- **Prudence:** Fiduciaries must invest in a manner consistent with "sound" investment decision-making;
- **Loyalty:** Fiduciaries must consider only the interests of fund beneficiaries when making decisions; and
- **Impartiality:** Fiduciaries need to take into account all fund beneficiaries, present and future, when making investment decisions.

These standards of care have evolved over time. Originally, fiduciaries were obliged to invest in the safest of investment products, and they were forbidden from investing in riskier investments such as public equities. The Modern Prudent Investor Rule (MPIR) informs current legal interpretation of fiduciary duty.[i] The MPIR departs from the traditional understanding of prudence by emphasizing the diversification and performance of a portfolio as a whole.

Fiduciary duty requires large institutional asset owners to have diversified portfolios designed to generate long-term sustainable wealth, while balancing the needs of current and future beneficiaries. These duties also include the twin goals of capital preservation and accumulation, although current interpretations of fiduciary duty generally define long-term sustainable wealth in exclusively financial terms.

The law makes clear that fiduciary duty does not expressly forbid impact investing by asset owners, though it does prohibit subordination of financial performance to social objectives, as we describe in more detail in Appendix B. To the extent that certain social and environmental risk factors affect long-term investment performance, fiduciaries may even be obliged to consider these factors in the decision-making process.[36]

Recent work on fiduciary duty and responsible investment has emphasized the importance that environmental, social, and governance (ESG) factors can play in portfolios with long-term time horizons. Issues such as climate change that pose substantial long-term risks are receiving special attention. Advocates argue that the interests of beneficiaries, understood as people rather than portfolios, support investments that create collateral environmental or social benefits.

Of special note is the importance of process and portfolio strategy in determining investment prudence. Two different fiduciaries that make the same investment may hypothetically receive different judgment in review. Prudence would depend on how the investment fits within a strategy suited to the overall purposes of the trust or endowment, and whether they conducted a thorough, meaningful, and rational due diligence process to determine its suitability.

Some public pension funds and other asset owners held to fiduciary duty standards have already successfully integrated ESG and impact investment into their investment policies. Generally, they have done so by preserving a focus on the due diligence process and by emphasizing investment selection based on financial performance.

Portfolio Theory and Investment Strategy

Though institutional asset owners have adopted a variety of strategies in managing their assets, there are a number of shared features in the market that reveal something about their approach to impact investing.

Though interest in the topic is growing, relatively few asset owners explicitly state their investment beliefs which include their thinking about how the market works and investments operate.[37] Still, we can draw some general conclusions about how institutional investors view the market from sources including portfolio management behavior, interviews, and a review of investment policies.

In large part, institutional asset owners currently draw from a set of beliefs about market efficiency and the benefits of portfolio diversification associated with Modern Portfolio Theory (MPT).[38] In brief, MPT offers a model of portfolio management that emphasizes diversification across asset classes. The MPT approach assumes that investors are rational, markets efficiently price assets, and a close relationship exists between an investment's risk and its return. MPT offers a framework for investors to seek uncorrelated assets as a way to reduce the overall volatility of their portfolios.

While many of the fundamental assumptions of MPT have been challenged in economic theory, in practice it remains the dominant investment guideline for U.S. institutional asset owners and has played a significant role in the comprehensive restructuring of large investment portfolios over the last 40 years. In the past, prudent asset management was seen to include only low-risk assets. Indeed, asset owners were only allowed to invest in public equities since the second half of the 20th century.[39] Now, large asset owners hold funds in multiple classes, not only in fixed income and public equities, but also in venture capital, private

Fiduciary Duty as an Evolving Construct

A number of recent reports examining the legal requirements of institutional investors in the U.S. have concluded that investments with social or environmental impacts are not by definition impermissible if returns are comparable and investors follow due diligence procedures. In the process, recent research has focused on the changes to fiduciary duty law over time, from its basis in ancient Roman and Islamic trust law to modern prudent investor standards.

The UN Environmental Programme Finance Initiative's 2005 Freshfields report echoes many other legal opinions when it finds that given existing regulations and case law, investors can take ESG considerations into account so long as they are "motivated by proper purposes and do not adversely affect the financial performance of the entire portfolio."[40] The paper traces the historical development of U.S. regulations like ERISA and case law to illustrate changing standards over time. It highlights that considering social and environmental impacts could be part of a diversification strategy. The UNEP-FI issued a follow-on report in 2009, which provided new legal developments and provided practical and legal guidance for incorporating ESG considerations into investment practice.[41] An October 2008 FSG Social Impact Advisors report lays out similar legal background for mission investing by foundations in the U.S.[42]

Exploring the links between fiduciary duty and responsible investment, recent research by James Hawley, Keith Johnson, and Ed Waitzer (2011) and Gordon Clark (2011) traces the development of fiduciary norms and their connection to economic events, such as the South Sea Bubble in the early 1700s, and acceptance of new economic and financial theories.[43] This research highlights that conceptions of fiduciary duty are not set in stone. Rather, changing realities and understandings of the world augment legal and conventional views of a trustee's fiduciary duty to beneficiaries.

[i] The theoretical foundations of current trust law rely on theories of efficient portfolio construction, which began to gain currency in the latter half of the twentieth century. In particular, the MPIR draws on a set of assumptions about the variability of asset prices across asset classes and the potential to minimize portfolio risk through asset diversification. The MPIR is reflected in most statutes and regulations that apply to institutional fiduciaries and in the corresponding case law. In the early 1990s, the Uniform Laws Council crafted two uniform statutes – the Uniform Prudent Management of Institutional Funds Act for endowments and the Universal Prudent Investor Act (UPIA) – to apply the standard to a wide range of fiduciary investors at the state level. Additionally, the Employee Retirement Income Security Act (ERISA) incorporated the MPIR into federal regulations governing the activities of private pension funds and employee benefit plans.

equity, real estate, commodities, hedge funds, and infrastructure. Diversification and MPT's risk management theories have encouraged product development in alternative asset classes like private equity and increased the range of investment managers and other services available to impact investors.

At the same time, diversification in line with MPT has encouraged funds to benchmark the performance of these portfolios with conventional, asset class-specific measures that compare investment risk and return performance. Benchmarks have become important tools for asset owners to assess the performance of consultants and fund managers who work for them. But they have also, in the aggregate, encouraged a herding of investment performance by setting benchmarks to which a vast number of investor's conform, in essence defining what market performance means for all investors.

We highlight three points here with regards to impact investing:

1. Performance measurement in terms of risk and return, as measured by MPT-driven understandings of market efficiency, encourages assessment of investment opportunities on a limited number of indicators. These indicators may not be connected to the underlying, long-term health of the business, nor the broader financial or non-financial impacts in society. Consequently, analysis of financial performance becomes divorced from the idea of sustainable wealth creation in the broader economy.

2. Though the expansion of investment opportunities across asset classes may help investors engage in impact investing, asset class-specific benchmarking has also helped develop relatively strong conventional preferences for types of investments within those asset classes. In other words, portfolio benchmarks favor standardized opportunities at the expense of idiosyncratic or innovative product approaches.

3. Critics have argued that many of these benchmarks encourage short-term performance at the expense of long-term returns by providing short-term measures of success and by serving as the basis for incentive-based remuneration for asset managers.[44] Short-termism reinforces the distance between evaluation of investment performance and its effects on the broader economy mentioned above.

Institutional investors and other stakeholders have attempted to address these concerns in recent years. A growing movement around responsible investment argues that over the long-term investment performance depends on ESG factors, which are often left out of conventional financial analysis. The United Nations Principles of Responsible Investment proposes that integrating ESG into investment analysis will improve long-term performance and "may better align investors with the broader interests of society." These Principles now have over 950 signatories worldwide, with some significant U.S. institutional investment support, though uptake in the United States has been slower than in Europe or Australia.

Also worth noting is the work by a number of U.S. foundation endowments on "mission investing," which is the practice of using endowment investments to support a public purpose organization's explicit mission goals. Though still a minority practice, mission investing has increased over recent years, and it has helped promote the idea that conventional portfolio strategies need not exclude consideration of a fund's positive social benefits. A recent Foundation Center survey found 168 of 1,200 responding foundations engaged in the practice.[45]

One important point about both responsible and mission investing: to date, practitioners who engage in these practices have tended to adopt conventional asset allocation policies and benchmarks for performance measurement, even as they have explicitly or implicitly criticized the ideas that underpin those strategies and benchmarks.

Institutional Structure and Service Provider Relationships

Though the management and structures of large institutional asset owners in the U.S. is not uniform, there is significant overlap among enough of these investors to allow for a group portrait.

For the most part, institutional asset owners manage their funds in close concert with external investment advisors and investment intermediaries, while a much smaller pool of investments, primarily at larger funds, are managed internally by fund staff. Whether managed internally or externally, asset owner trustees determine investment strategies. Trustees then delegate the execution of those strategies to staff or external service providers.

But this intersection of stakeholders involved in fund management is more complicated than the simple model of strategy setting and execution would suggest. Even if trustees are aligned and clearly state their investment beliefs and strategy, the execution of that strategy depends on the skills of staff and external service providers to implement it. Practically speaking, implementation means translating investment policies, including them in Requests for Proposals to service providers, and building systems that measure performance.

In most cases, staff and investment consultants, who have more knowledge of and contact with the fund's investment portfolios compared to trustees, exercise substantial control over both the investment decisions that trustees make and the communication of those decisions to fund managers and other stakeholders. The various power relationships and information flows that emerge from the interactions of trustees, staff, and service providers help define the investment ecosystem in which fund assets are put to work.

Finally, as noted, the agency issues involved in governing complex service provider relationships are vital to determining how investment performance is achieved, managed, and evaluated. To the extent that those incentives disfavor the consideration of social benefit, the asset owner institutional structure will hinder the uptake of impact investing.

APPENDIX B: INSTITUTIONAL ASSET OWNER IMPACT INVESTING PRACTICES

In this section, we describe how institutional asset owners participate in impact investing ***as currently practiced***. These are not examples of ideal types of investment strategies, but rather a survey of activity on the ground.

We can think about impact investments by institutional asset owners in two ways: as portfolio-level strategies and as asset class-specific applications of those strategies. Portfolio-level strategies, such as economically targeted investing by pension funds and most sophisticated mission investing strategies by foundations, tend to involve multiple asset classes and investment vehicles. The application of those strategies, in keeping with the broader asset allocation strategies of asset owners, is largely within particular asset classes such as infrastructure or fixed income.

The presence of investments with impact in an asset owner's portfolio does not necessarily reflect an impact investment strategy. Most investments by institutional asset owners are through fund intermediaries. While an institutional investor may not explicitly support a particular impact objective, we consider investment in an intermediary that is clearly committed to delivering measurable social and environmental benefits to be an impact investment.

PORTFOLIO STRATEGIES

Explicit impact investing strategies and broad impact objectives sit at the portfolio level. They may or may not be contained in explicit investment policy statements or fund strategy documents. Impact strategies may have a variety of different names – ESG integration, economically targeted investing, and mission investing – but they all focus on seeking out investments with a particular type of impact throughout the portfolio.

Institutional Investors and Climate Change

Over the past decade, the issue of climate change has received significant attention from institutional investors. Among the more prominent venues for this interest has been engagement with corporations and public policy via investor groups such as the Investor Network on Climate Risk. This research and advocacy group highlights both the risks of climate change to long-term investment returns and opportunities to improve corporate governance and public policies that address that risk.[46] The recent report "Climate Change Scenarios – Implications for Strategic Asset Allocation," released by Mercer Investment Consulting in conjunction with the Carbon Trust and the International Finance Corporation, concludes that investors can better manage climate risk by increasing asset allocations to real assets and sustainable investments.[47]

Some asset owners already directly engage with fund managers on climate risk. For instance, the North Carolina Department of State Treasurer conducted a survey of its real estate fund managers to determine how they manage climate risk in their holdings in order to better assess the state pension fund's exposure to long term risk.

The State of California has begun to make investments with an eye toward climate change. Recently, the state invested $700 million in World Bank green bonds that will fund reforestation, alternative energy, and water purification projects. In announcing the second, $400 million tranche of investment from the state's Pooled Money Investment Account, State Treasurer Bill Lockyer emphasized the state's intent, stating "We're earning an excellent return, strengthening our portfolio and backing our policies with money in the fight against global warming."[48]

Environmental, Social and Governance (ESG) Integration

Advocates argue that the integration of ESG information into investment decision-making can enhance long-term investment performance by more closely linking investment strategies to macro trends – such as climate change, resource scarcity, urbanization, demographic shifts, and polarization of wealth – likely to affect risk and return over time. The implication is that the conventions of short-term benchmarking and agency issues among owners, managers and consultants have inhibited the pricing of externalities and accounting for market-driving environmental and social dynamics.

The emergence of the United Nations Principles of Responsible Investment (UN PRI) in 2005 highlighted the increasing practice of ESG integration. A substantial number of asset owners, fund managers, and consultants have subscribed to the PRI – with now over $30 trillion in assets under management committed to their implementation. Uptake in the United State has been slower than in Europe or Australia but significant nonetheless.

ESG integration offers a potential platform for impact investing to the extent that this integration focuses on positive social and environmental returns. The preamble to the UN PRI highlights the link between ESG integration and the potential for positive impact returns by asserting that "applying these Principles may better align investors with broader objectives of society."[49] In practice, signatories to the UN PRI have focused their efforts on identifying high performing companies for public equity stock selection, engaging companies on their ESG practices, and building systems for applying ESG analysis across asset classes. Climate risk and corporate governance have been central focuses, though a number of emerging efforts are elaborating on the role that social issues like human rights, worker relations, and community engagement may play in investment decisions.

Economically Targeted Investing

The practice of economically targeted investing (ETI) dates back to the 1980s and is most commonly is most commonly associated with public pension funds. Economically targeted investments (ETIs) have additional, place-based economic benefits besides the financial return accruing to the fund. By design, ETIs are a double-bottom line investment strategy that targets financial return as well as economic growth in areas related to beneficiaries. ETIs take many shapes and forms from targeted private equity or loan programs, which require intermediaries to invest all or a portion of assets in operating businesses within a predetermined geographic area, to targeted real estate and infrastructure investments.

Florida Growth Fund

In May 2008, the Florida State Legislature passed Senate Bill 2310,[50] allowing the Florida State Board of Administration (SBA)[51] to invest up to 1.5 percent of the $130 billion Florida Retirement System (FRS) in businesses domiciled in Florida in technology and other growth sectors. For the Legislature, investments by Florida pension funds in technology and other growing industries presented the potential to generate high-growth and high-wage jobs that would economically benefit the state. In the words of sponsoring state Senator Jeremy Ring, "Prudently harnessing the power of the state pension fund holds the promise for our state to become a national leader in innovative, high-tech fields and innovative, high-paying jobs."[52] The law was designed to mirror economically targeted investment policies for state pension funds in New York, Massachusetts, Ohio, Texas, and California.

Senate Bill 2310 led to the creation of the Florida Growth Fund[53] in 2009, which has $500 million under management, intended to enhance Florida's capacity for development, growth and innovation while generating an attractive return for the Florida SBA and FRS. The Fund targets businesses and industries located in Florida, including clean technology, biotechnology, healthcare, information technology, and aerospace. The Fund is managed by Hamilton Lane and deploys capital both through private equity fund intermediaries and direct co-investments.

The ETI policy adopted by the Washington State Investment Board in July 2006 provides an example of how institutions may approach targeted investing:

- The Board will consider for investment only those ETIs that are commensurate on a risk-adjusted financial basis to alternatively available investments;
- The decision to invest in an ETI in consideration of its collateral benefits shall be made only after the opportunity is deemed acceptable exclusively on its economic investment merits;
- The collateral benefits of an ETI shall not be considered part of the return of the investment, nor a part of risk reduction;
- ETIs shall be made in accordance with the Board's approved asset allocation policies and included within existing asset categories, and shall conform to all laws, policies, and procedures governing the Board; and
- ETIs shall receive the proper level of due diligence and evaluation consistent with all other investment opportunities evaluated of similar type or classification.[54]

Following the 2008 financial crisis, a renewed interest emerged in new forms of ETIs and the expansion of existing practices. In Massachusetts, for example, the state legislature approved $25 to $50 million in additional allocation for investments in banks and financial institutions making small business loans in-state, adding to MassPRIM's nearly $300 million in existing ETI outlays in fixed income and venture capital.[55]

More recently, CalPERS announced in September 2011 that it had earmarked up to $800 million for investments in California infrastructure over the next three years in transportation, energy, natural resources, utilities, water, communications and other social support services, adding another asset class to its ETI policy.[56]

The President of the CalPERS Board of Administration explained this decision by saying: "We are prepared to increase our investments in infrastructure with our first and foremost goal being on investment returns, and a secondary goal of supporting essential community services that are crucial to continued economic development, a safe environment, and healthy schools and communities."[57]

Additionally, a number of funds have preferential "emerging domestic manager" programs, which seek out and invest in funds with minority and women investment professionals and owners. The impact of these investments is not measured by their results, but in the placement of the funds, with the intent of developing a diverse supply of investment intermediaries.

Mission Investing

A number of leading U.S. foundations that engage in mission investing have developed portfolio-wide strategies for targeting social impact. For instance, the F.B. Heron Foundation sets clear criteria for the types of positive social impact sought, in this case, the development of wealth creation strategies for underserved communities. It then seeks out investments that help achieve these goals across a range of asset classes and risk/return profiles.[58] The Meyer Memorial Trust has adapted a mission investing strategy to further its goals – positive social impact in Oregon and Clark County, Washington – to include investments in the region that create positive social impact beyond the foundation's immediate issue-specific and geographic focus.[59]

The market-rate investments of these foundations have ranged from fixed-income products that target specific regions or communities, to urban regeneration and green building funds in real estate, to public equities investments that favor corporate engagement on ESG issues. Both foundations work with their in-house investment staff and external consultants to benchmark their market-rate mission investments in a manner consistent with any other asset in their portfolio, in a process suitable for the range of institutional asset owners considered in this study.[60]

ASSET CLASS APPLICATIONS

Institutional asset owners typically apply their investment strategies within the constraints of asset allocation decisions that define their portfolios. They target impact investment strategies within asset classes, and typically use conventional asset class benchmarks and tools to make their decisions about investability.

We have highlighted several examples of impact investments by asset class below. This list is illustrative, not comprehensive; many impact objectives are realized in products in other asset classes.

Cash and Cash Equivalents

Institutional asset owners, like pension funds and endowments, have benefitted local economies by investing a portion of their cash assets in local financial institutions and community banks. In 2010, Seattle University set aside $100,000 of its operating account for investment in Community Capital Development, a CDFI that provides assistance, training and loans to small businesses in distressed and underserved communities in the Seattle area, especially those operated by low-income, women and minority entrepreneurs.[61]

Minnesota-based Macalester College made a $500,000 investment from its operating account in University Bank, a CDFI that supports economically distressed communities in the Twin Cities.[62]

Other organizations have chosen to move all their operating accounts and banking services to community-based banking institutions. For example, the Winthrop Rockefeller Foundation has moved all of its banking operations to Southern Bancorp, a CDFI serving the rural Mississippi Delta.[63]

Certificates of Deposit (CDs) made in CDFIs provide another form of impact investment in cash available to institutional asset owners. The W.K. Kellogg Foundation currently has 11 cash investments in its mission-investing portfolio. These range from $250,000 to $4 million placements in CDFIs and other banking institutions that target the geographies, populations, and issues that are consistent with Kellogg's mission. This strategy is made possible, in part, by the Certificate of Deposit Account Registry Service (CDARS), which offers FDIC insurance on large scale deposits.[64]

The State of Wisconsin Investment Board has maintained a CD program since 1987, which now authorizes them to invest up to $500 million in CDs issued by Wisconsin-based banking institutions.[65] The State Treasurer's Office in Iowa has run a similar program since 1983, investing state operating funds in six-month competitive CDs at Iowa-based banks.[66] In 2009, Invest in Iowa CDs composed 4.35% of the operating fund's $4.2 billion average daily balance.[67]

Fixed Income

Fixed income investments, which include bonds and other fixed-return debt instruments issued by a variety of institutions, were traditionally the main component of institutional asset owners' portfolios. Fixed income is generally perceived as a safe and stable asset class – notwithstanding the more complex and riskier products such as collateralized debt securities and the mortgage-backed products that featured prominently in the 2008 financial crisis – and the opportunities for investing with impact in fixed income instruments are plentiful. Asset owners can look for securities that support sectors or projects related to low income and affordable housing, business development, infrastructure, or the environment; they can invest in securities issued by governments for public goods projects related to education and health care in underserved communities; and they can engage with corporations on ESG issues with corporate debt securities.

State of Wisconsin Investment Board Provides Financing to Local Businesses

Investment funds managed by state governments can add impact to their investing, while still maintaining fiduciary commitments, in the form of debt by offering senior or subordinated financing directly to local businesses.

As part of its "Invest in Wisconsin" policy to support businesses with a local focus, the State of Wisconsin Investment Board (SWIB) has offered senior and subordinated debt financing since the 1960s to companies headquartered or operating in the state.[68] SWIB offers this financing through its Private Loan Program as senior fixed-rate or subordinated loans ranging from $3-40 million, with the average loan around $10 million.[69] These are fixed-rate intermediate and long-term loans intended primarily for financing fixed assets or refinancing existing debt. Fixed assets of the business are offered as collateral. Conditions of the loans match current market interest rates and terms, allowing SWIB to meet its fiduciary obligations.

The General Board of Pension and Health Benefits of the United Methodist Church's Positive Social Purpose Lending Program (PSP) has invested over $775 million since 1990 in fixed income securities to promote affordable housing, community development, and expanded loan opportunities for poor communities nationally and internationally.[70] Since inception, the PSP program has funded the construction, rehabilitation, or preservation of over 30,000 affordable housing units in all 50 states while receiving market-rate returns.

A number of investors, including public pension and Taft-Hartley funds, have made similar investments in the AFL-CIO Housing Investment Trust (HIT). HIT is a $4 billion fund that invests in multifamily and single family mortgage-backed securities and other mortgage-related securities with a focus on creating union jobs, expanding the supply of housing, promoting homeownership, and contributing to community development. HIT investments have created 69,000 union construction jobs and built more than 100,000 units of multifamily housing since its creation in 1981.[71]

Public Equities

Over the past decade, institutional investors have adopted corporate engagement strategies across a variety of ESG issues ranging from environmental performance, to executive compensation, to health, safety, and labor standards in corporate supply chains. To the extent that these strategies use the voice of the shareholder to affect positive social change in publicly held corporations, they may be considered impact investments. However, we should note that some might view those impacts as less tangible than investment in private equity, debt, real estate, or other products that may imply a closer connection between investor intent and social outcome.

The most common practice of investment activism by institutions – and activism inevitably requires intent – is in the area of corporate governance. Many of the largest institutional investors now take an active role voting proxies and advocating for board and management reform at public companies to protect the value of their investments.

Often this activism veers into the social and environmental. For example Glass Lewis, advisors to institutional investors with over $17 trillion in assets, recommended a vote against BP's annual accounts and reports in April 2011 to protest the lack of information provided by BP to investors regarding its risk mitigation strategies in the wake of the Gulf of Mexico oil spill.[72]

Corporate Disclosure and Environmental, Social and Governance Performance

A number of policy advocacy groups have focused on reforming corporate disclosure regulations to incorporate ESG information into corporate reporting by publicly traded companies. In theory, clear comparable data in corporate reporting would allow investors to better factor in ESG information that has long-term implications for business performance and social impact. Work done by standard setting institutions in the disclosure community, such as the Global Reporting Initiative, has raised awareness and increased reporting on a voluntary basis through advocacy and reporting standard development.[73]

Investors and advocates in the SRI community like the Interfaith Center on Corporate Responsibility (ICCR), Ceres, and, more recently, the International Integrated Reporting Council (IRRC) have focused on the regulatory environment around corporate reporting as a way to increase the availability of ESG information.[74] For example, in July 2009, U.S. SIF: The Forum for Sustainable and Responsible Investing wrote to the Securities and Exchange Commission (SEC) asking the Commission to require corporate reporting on universal and industry-specific sustainability indicators, with interpretive guidance for how management should address these issues in the narrative section of their corporate report.[75]

While progress on the reporting of corporate non-financial performance in the U.S. at the regulatory level is slow, there are a number of countries and stock exchanges globally that have mandated disclosure of ESG information at some level or another, including Australia, Denmark, Greece, Japan, Malaysia, and South Africa.[76]

Institutional investors may also adopt stock selection strategies that target environmental and/or social outperformance, incorporating ESG research to anticipate the long-term effects on shareholder value. Some of these strategies – such as stock portfolios that target companies with superior worker engagement, community relations, environmental performance, or governance policies – may fit institutional investor definitions of impact investing. These strategies often depend on transparency on ESG issues in the marketplace, and therefore public policies on corporate disclosure can play a particularly important role in shaping market activity.

Perhaps most important for the purposes of this paper, the activity in public equities markets around ESG issues suggests an approach compatible with impact investing. Long-term value is seen to correspond with positive social impact where institutions use their rights as shareholders to influence the board and management practices of public companies.

In positive ESG screening, asset owners direct public market investments to companies that are either "best-in-class" on nonfinancial issues of concern to investors or are perceived to have a proactive social or environmental impact, according to the analyses of independent third-party research organizations.

Real Estate and Other Real Assets

Investments in real estate, as with other real assets, can offer tangible social and environmental impacts. In real estate, the role that public policy plays in shaping investment strategies is illuminated by the close connection of financial returns to building codes, land use policies, and the need to gain licenses to operate from public officials and community groups.

In recent years, institutional investors have adopted a number of strategies for incorporating ESG analysis, as well as searching for ancillary social impacts, in their real estate portfolios. The past decade in particular saw the development of urban investment strategies that sought to capitalize on underused assets in metropolitan markets. These strategies often took advantage of tax subsidies for investments with specific social benefits or targeted to underserved communities.[77] Particular areas of impact include affordable and workforce housing, smart growth and transit-oriented development, and brownfield redevelopment.

Green building is perhaps the fastest growing impact area in recent years. Major fund managers have developed green real estate strategies for new construction and are increasingly pursuing energy efficiency strategies across their existing building portfolios, often driven by inquiries from the asset owners who invest with them.

In other types of real assets, specifically sustainable land management, the growth of forestry as an asset class has led to the development of impact investing products that support sustainable timber production. A number of intermediaries in this area now seek properties with high conservation value, often in partnership with nonprofit organizations or government agencies. For example, Lyme Timber clients include a number of mission-related investors from the foundation endowment community and institutional asset owner clients who have invested in the fund without intentionally targeting environmental benefits.

Real Estate Impact Investing – CalPERS California Urban Real Estate Initiative (CURE)

Besides serving the needs of government employees, state pension funds can extend their impact by allocating a portion of their investments toward the state's underserved communities. Since 1995, the California Public Employees Retirement System (CalPERS) has made targeted investments in real estate projects to revitalize California's inner-city neighborhoods through its California Urban Real Estate Initiative (CURE). The program is a major component of CalPERS's ETI goal to invest 2% of the fund in programs that enhance economic development within the state. CURE focuses its investments specifically in underserved urban neighborhoods in projects that develop or rehabilitate housing, retail space and other properties.

Investments in CURE projects are based purely on economic merit, with the same expectations for risk and return as other fund investments. But by helping to fill the capital gap in this market, CURE projects also provide collateral social benefit by creating jobs, increasing the supply of moderately priced housing and improving the general infrastructure in California's metropolitan areas. To mitigate risk, CalPERS invests as a limited partner in collaboration with external real estate developers.[78]

Private Equity

The field of impact investing has often focused on private equity, and particularly early-stage venture capital and "angel" investing, as exemplary asset classes. Venture capital funds have emerged that focus on new technologies for renewable energy production or energy efficiency improvements or support for social enterprises. These funds combine a sense of dynamism, the potential for scale, tangible social benefits, and close contact between investors and investees that have appealed to early adopters of impact investing. Though less involved to date compared to these subsets of venture capital, private equity also offers limited partners the potential for close contact with investees, and the potential for targeted investments in job creation, economic development, or environmental strategies.

While institutional investors have been less active than their counterparts in impact investing in private equity, larger scale investments in energy infrastructure, sustainable real estate and other real assets often have private equity structures and offer institutional asset owners the potential to invest substantial sums of money.

Private equity intermediaries (known as general partners, or GPs) have also begun to take ESG criteria into consideration in investment decisions at the fund level, with funds that target impact investing issues including sustainable corporate practices, energy efficiency and clean energy production, and labor rights. The UN Principles for Responsible Investment has a Private Equity work stream that is encouraging the incorporation of ESG by GPs, and has developed a guide for limited partners on this practice.[79] Additionally, the Institutional Limited Partners Association published in 2008 a review of best practices for the 'creation, implementation, and development' of targeted private equity programs, recognizing the increase in institutional investment and interest in such funds.[80]

Some of the largest single impact investments have been made in private equity. The most notable examples are two CalPERS programs: the California Initiative, which directs over $1 billion in private equity capital to underserved communities in California, and the $600 million Environmental Technology Program that aims to support the development of more efficient and less polluting products, services, or technologies.[81] In the field of mission investing, the F.B. Heron Foundation has invested $14.5 million of its mission-related investing portfolio in six market-rate private equity funds in California and New York to support job growth and the development of workforce housing.[82]

Additionally, institutional asset owners – especially endowments, which have more flexibility and resources for these sorts of complex deals – have worked to create their own private equity funds to support particular targeted goals. The California Endowment's California Freshworks fund and the Bay Area Transit-Oriented Affordable Housing Fund are two such examples of equity-like structures designed by institutional asset owners to serve particular impact purposes not currently served by existing products.[83]

When attempting to invest with impact, private equity faces challenges as well. While limited partners can have close contact with some funds, lack of transparency or governance structures can limit partner influence. Careful balancing of fund goals with the challenges of deal generation and monitoring are also important issues in the relatively illiquid private equity market. On the other hand, the potential for longer term time horizons and close engagement in private equity investments also offers impact investors the opportunity to target high impact strategies.

APPENDIX C: THE FIDUCIARY OBLIGATIONS OF INSTITUTIONAL ASSET OWNERS[84]

Introduction

Institutional investors have a legal duty of loyalty and impartiality that requires them to administer funds in the sole interest of beneficiaries.[85] A high standard of loyalty is the primary mechanism for preventing fiduciaries from making decisions that benefit themselves or third parties over beneficiaries.[86]

Fiduciaries are also required to act with prudence and care in making investment decisions while tailoring their portfolios to suit their unique investment objectives. The duty of prudence is based on the premise that portfolio diversification is central to performance. Guided by this standard, fiduciaries should apply prudence at the portfolio level, as well as at the level of an individual investment.

These duties and the corresponding standards of care vary only slightly from institution to institution, even though the underlying laws that govern different classes of asset owners may differ.

The Duties of Care and Prudence

The fiduciary relationship and standard of care arose from the need to protect trust beneficiaries from conflicts of interest and the powerful incentive for self-dealing by trustees. Fiduciary standards were developed to solve the agency problem: an agent (in this case, the trustee) charged with managing assets to suit the interests of one or more trust beneficiaries will invariably encounter situations that force decisions about how best to deploy assets to meet those needs. In some cases, a conflict may arise between beneficiaries' interests and a trustee's own personal economic or professional interests.

In such situations, the highest standard of fiduciary care is required, one that places the full force of law behind the protection of beneficiaries and their interests. As described by Justice Cardozo, it requires a trustee to adhere "to something stricter than the morals of the marketplace. Not honesty alone but the punctilio of an honor the most sensitive..."[87]

Within this elevated standard of care, fiduciaries also have the duty of prudence in investment, which has evolved over time since its origin in traditional English trust law. For example, while the standard of care once considered investment in equities too risky for fiduciaries, it now accepts the notion that investment strategies designed to preserve capital may be more vulnerable to certain kinds of risk – namely inflation risk – and that trust beneficiaries also have an interest in capital appreciation and investment return.

A more flexible standard of prudence, embodied in the American Law Institute's Second Restatement of Trusts, now enables fiduciaries to balance the competing interests of beneficiaries in capital preservation and appreciation.[88]

Another important development in trust law comes from Modern Portfolio Theory (MPT), a theory of efficient portfolio construction that began to gain currency in the latter half of the twentieth century. As discussed in this report, MPT relies on traditional assumptions about the statistical properties of asset prices to demonstrate that portfolio risk can be minimized through asset diversification.

The Duties of Loyalty and Impartiality

Regardless of the particular rules that govern their investment function, all fiduciaries must also fulfill duties of loyalty and impartiality to beneficiaries. These duties apply to all aspects of trust management including investment decisions and benefit payout. Although concerns about prudence often dominate the conversation about fiduciary liability with respect to investment decisions, the corresponding duties of loyalty and impartiality also factor significantly into these decisions.

The duty of loyalty, often described as the "exclusive benefit" rule, requires fiduciaries to administer the trust in the sole interest of beneficiaries.[89] It derives from the common law of trusts and has been integrated into the prudent investment standard and relevant statutes. A high standard of loyalty deals directly with the problem of trustee conflicts of interests. It generally prohibits fiduciaries from making decisions that benefit themselves or third parties over beneficiaries.[90]

Related to the duty of loyalty is the duty of impartiality, which maintains that fiduciaries must deal impartially with all current and successive beneficiaries.[91] The duty of impartiality may appear straightforward, but in practice, impartiality may require significant tradeoffs. For example, investments that generate the greatest return today may put the corpus at risk for future beneficiaries. On the other hand, a conservative investment strategy designed to limit investment risk and generate predictable income might net lower overall returns and subject the corpus to other kinds of risk over time.

Fiduciaries subject to the duty of impartiality must balance the competing interests of different classes of beneficiaries by developing an investment strategy that matches the trust's objectives, addressing income, risk, and return requirements at the portfolio level. By requiring trustees to diversify investments and consider an investment's contribution to the portfolio as a whole, Modern Portfolio Theory affords them greater flexibility to deal impartially with beneficiaries than previous standards of prudent investment.[92] At the same time, the theoretical and practical limitations of MPT leave considerable room for improvement in the way we think about financial performance.

LEGAL STANDARDS – BY TYPE OF INVESTOR

Although the fundamental duties of all fiduciaries are ultimately the same, the legal and institutional contexts of different classes of fiduciaries remain varied and complex. The following sections provide an overview of the legal environment, including key statutes, rules and court decisions surrounding investment by four main classes of fiduciaries: private and public pension funds, endowments (including universities) organized as charitable corporations, and insurers.

Private Pension Funds

The federal laws governing investment activity by private pension funds are widely considered the most restrictive, chiefly based on their interpretation by federal agencies. The Employee Retirement Income Security Act (ERISA), passed by Congress in 1974, is the controlling statute for private pension investment and management. It is meant to protect plan beneficiaries from abuse and misconduct by fiduciaries, and it provides minimum standards for reporting and disclosure, participation and vesting, and fiduciary responsibility. ERISA applies to employee benefit plans sponsored by any private employer or union, and it supersedes existing state laws governing investment by private pensions.

At its most basic, ERISA requires plan sponsors to disclose the details of a plan to beneficiaries and the government and to adhere to the imperatives of fiduciary duty in managing, investing, and distributing plan assets. Fiduciaries under ERISA must act according to the "prudent man rule," that is, with care, skill, prudence, loyalty and diligence. The statute incorporates an affirmative duty of diversification.

With respect to the duty of loyalty, ERISA charges trustees and fiduciaries with administering the plan "solely in the interest of the participants and beneficiaries, and for the exclusive purpose of providing benefits to participants and beneficiaries…"[93] This is known as the "exclusive benefit" rule.

Public Pension Funds

The management and operation of public pension plans sponsored by government employers is generally subject to state law. Although specific investment controls may vary by state, all require pension trustees to adhere to the same standards of fiduciary duty outlined above. In an effort to harmonize prudent investments standardsacross state lines and institutional classes, 47 states have adopted the Universal Prudent Investment Act (UPIA).

Like ERISA's standard of fiduciary behavior, UPIA takes a form of Modern Portfolio Theory as the basis for prudent investing, creating an affirmative duty of diversification of assets. In full, the UPIA enumerates eight specific factors that fiduciaries must take into account as part of a prudent investment process, including expected total return, economic risks and conditions, and the purpose and needs of the trust. By requiring fiduciaries to balance a range of considerations, the law provides some flexibility to craft an investment strategy that reflects the diverse interests of trust beneficiaries.

Nonprofit Corporations and Endowments

Charitable endowments organized as nonprofit corporations receive somewhat different legal treatment than traditional trusts, although the underlying principles of fiduciary duty are ultimately the same. Charities, including university and college endowments that are organized as corporations, are not considered private trusts. Although they may have a mission to serve a subset of the general populace – for example, the current and future students of a particular college – their beneficiary is the public itself.

In addition to their fiduciary duty as entities formed in the public interest, nonprofit corporations also enjoy tax-exempt status in exchange for their public welfare benefits. Thus, nonprofit trustees are under a dual but sometimes conflicting obligation to invest assets prudently in accordance with state corporate law while not jeopardizing the organization's ability to carry out its tax-exempt purposes.[94]

Insurance Companies

Insurance companies are governed at the state level and are generally subject to state corporate law. Corporate officers and directors must exercise normal business judgment in managing the company and when investing company assets. This "business judgment rule," as it is called, differs from the prudent person standard in that it protects directors and officers from liability for their decisions if they can be shown to be "disinterested and independent"; in other words, they are acting in good faith and not subject to conflicts of interest.

To the extent that they provide retirement and life insurance benefits to individuals and families, however, insurers are subject to ERISA and its stringent standard of care and prudence. This double standard means insurance companies have more latitude in managing their general-purpose assets than in the assets they manage on behalf of beneficiaries.

APPENDIX D: ECONOMICALLY TARGETED INVESTMENT POLICIES

The following chart is not meant to be an exhaustive catalogue, but rather an illustration of the types of language and policies around ETIs that exist for state pension funds across the U.S.

As demonstrated, many states and public pension funds include language in laws or investment policies referencing economically targeted investments. Each state governs its public pension funds differently, with varying language and specificity over allowable and prohibited investments.

For the purposes of this report, we have grouped policies related to economically targeted and in-state investments into two categories—policies that mandate, allow for, or encourage ETIs, and those policies that discourage such investments. It is worth noting that even those policies that discourage ETIs do not explicitly prohibit investments with positive social or environmental benefits. In cases like Kansas state law and the Maryland State Retirement and Pension System, such investments are required to be assessed on economic merits alone, which still allows in-state investments with positive social benefits to be considered if they meet the financial standards of comparable investments.

The majority of states and pension funds recognize the mutual benefits of in-state pension fund investments and explicitly encourage such activity, well-illustrated by the Retirement Systems of Alabama and Hawaii state law. It is interesting to note that, even where states and pension systems appear to have no explicit policy on ETIs, some like the Nevada Public Employees' Retirement System, Indiana Public Employees' Retirement Fund, and the Minnesota State Board of Investments have engaged in and report on ETIs.

STATES AND FUNDS	MANDATE, ENCOURAGE, OR ALLOW ETIs	DISCOURAGE ETIs
ALABAMA		
Retirement Systems of Alabama	**Board Investment Policy** *Board Obligations* The Systems recognize that a stronger Alabama equates to a stronger Retirement System, and as such, investments in Alabama businesses are encouraged to the extent the investment meets the criteria delineated by this policy statement.[95]	
ALASKA		
Alaska Permanent Fund	**State Law** *Alaska Statute Sec. 37.13.120: Investment Responsibilities* (c) The board shall invest the assets of the fund in in-state investments to the extent that in-state investments are available and if the in-state investments: (1) have a risk level and expected return comparable to alternate investment opportunities; and (2) are eligible for investment of fund assets under (a) of this section.[96]	
ARIZONA		
Arizona State Retirement System	**State Law** *Arizona Revised Statutes 38.719 (c)* Notwithstanding any other law, investment management shall not be required to invest in any type of investment that is dictated or required by any entity of the federal government and that is intended to fund economic development projects, public works or social programs but may consider such economically targeted investments pursuant to its fiduciary responsibility.[97]	
ARKANSAS		
Arkansas State Retirement Systems	**State Law** *Arkansas Code 24.2.608: Investment authority and limitations – Arkansas-related investments.* (a) In acquiring, investing, reinvesting, exchanging, retaining, selling, and managing funds held by each of the trusts, fiduciaries administering the systems shall manage the funds so as to favorably impact the economic condition of and maximize capital investment in the State of Arkansas when appropriate investment alternatives are available. (b) It is the intention of the General Assembly that, as assets become available for investment, the systems shall seek to invest not less than five percent (5%) nor more than ten percent (10%) of their portfolios in Arkansas-related investments.[98]	

STATES AND FUNDS	MANDATE, ENCOURAGE, OR ALLOW ETIs	DISCOURAGE ETIs
CALIFORNIA		
California Public Employees' Retirement System	**Board Investment Policy** *Statement of Investment Policy for Economically Targeted Investment Program* The target allocation to ETIs shall be 2% of Fund assets… The existence of this Policy shall not be construed as a mandate to invest in ETI's, but rather should be viewed as an additional set of suggested parameters within which to consider such investments.[99]	
California State Teachers' Retirement System	**Board Investment Policy** *Policy on California Investments* The goal for California emerging markets investments shall be 2% of CalSTRS' total investment portfolio. The Board shall periodically reevaluate the 2% goal.[100]	
COLORADO		
Public Employees' Retirement Association of Colorado	**State Law** *Colorado Revised Statues 24.51.206* The board shall have complete control and authority to invest the funds of the association. Preference shall be given to Colorado investments consistent with sound investment policy.[101]	
CONNECTICUT		
Connecticut State Employees Retirement System	**Board Investment Policy** *Investment Policy Statement, Article XIV* While maintaining the principles of prudent investment standards and seeking market returns, the CRPTF may, as a matter of policy, channel a portion of its investments (as agreed to by the Treasurer in consultation with the IAC) into under-served urban and rural markets with a special interest in investment opportunity targeted in Connecticut, while at the same time achieving any necessary geographical diversification.[102] **State Law** *General Statutes of Connecticut 32.3.13d* Among the factors to be considered by the Treasurer with respect to all securities may be the social, economic and environmental implications of investments of trust funds in particular securities or types of securities.[103]	
FLORIDA		
Florida State Board of Administration	**State Law** *Florida Statutes 215.47 (7)* The State Board of Administration, consistent with its fiduciary duties, may invest up to 1.5 percent of the net assets of the system trust fund in technology and growth investments of businesses domiciled in this state or businesses whose principal address is in this state.[104]	

STATES AND FUNDS	MANDATE, ENCOURAGE, OR ALLOW ETIs	DISCOURAGE ETIs
HAWAII		
Hawaii Employees' Retirement System	**Board Investment Policy** *Hawaii Targeted Investment Program (HiTIP)* The Hawaii Targeted Investment Program (HiTIP) is one component of the HIERS private equity portfolio. The HIERS has established HiTIP to participate in attractive long-term alternative investment opportunities in emerging growth businesses in traded sector industries, emphasizing the greater-Hawaii geographic region.[105] **State Law** *Hawaii Revised Statutes 88.119.11* In evaluating venture capital investments, the board shall consider, among other things, the impact an investment may have on job creation in Hawaii and on the state economy. The board shall report annually to the legislature on any Hawaii venture capital investments it has made; provided that if the board determines it is not prudent to invest in any Hawaii venture capital investments the board shall report the rationale for the decision.[106]	
IDAHO		
Public Employees' Retirement System of Idaho	**Board Investment Policy** *V. Asset Class Policies* The Fixed Income Asset Class shall consist of investments in mortgages and in both dollar and non-dollar fixed income securities. Mortgages shall consist of investments in mortgage backed securities, and direct ownership of commercial mortgages through the Idaho Commercial Mortgage Program.[107]	
IOWA		
Iowa Public Employees' Retirement System	**State Law** *Iowa Code 97B.7A (2)* Consistent with this section, investments shall be made in a manner that will enhance the economy of this state, and in particular, will result in increased employment of the residents of this state.[108]	**Board Investment Policy** *III. K. Social Investing* As fiduciaries, the IPERS Investment Board, staff, and investment managers must perform their duties for the exclusive benefit and in the best economic interest of the System's members and beneficiaries. The System and the Board will not support investment policies or strategies which seek to promote specific social issues or agendas through investment or divestment of IPERS' assets.[109]

STATES AND FUNDS	MANDATE, ENCOURAGE, OR ALLOW ETIs	DISCOURAGE ETIs
KANSAS		
Kansas Public Employees' Retirement System	**State Law** *Kansas Statute 74-4921. (3)* Moneys in the fund shall be invested and reinvested to achieve the investment objective which is preservation of the fund to provide benefits to members and member beneficiaries, as provided by law and accordingly providing that the moneys are as productive as possible, subject to the standards set forth in this act. No moneys in the fund shall be invested or reinvested if the sole or primary investment objective is for economic development or social purposes or objectives.[110]	
KENTUCKY		
Kentucky State Police Retirement System Kentucky County Employees' Retirement System	**State Law** *Kentucky Revised Statutes 16.642 (3); Kentucky Revised Statutes 78.790* The board, in keeping with its responsibility as trustee and wherever feasible, shall give priority to the investment of funds in obligations calculated to improve the industrial development and enhance the economic welfare of the Commonwealth.[111]	
Kentucky Employees' Retirement System	**State Law** *Kentucky Revised Statutes 61.650 (3)* The board, in keeping with its responsibility as trustee and wherever consistent with its fiduciary responsibilities, shall give priority to the investment of funds in obligation calculated to improve the industrial development and enhance the economic welfare of the Commonwealth.[112]	
LOUISIANA		
Teachers Retirement System of Louisiana	**Board Investment Policy**[113] *III. Review of Investment Guidelines* As required by Act 788 of 2003, the Teachers' Retirement System of Louisiana ("TRSL") Board of Trustees approved the establishment of a pilot program for investing in venture capital, emerging businesses, and money managers focused on Louisiana (the "Program"). The Program is intended to enhance economic development in Louisiana by stimulating job creation and capital formation through investments in Louisiana businesses, as well as result in a market rate of return for TRSL.[114]	
Louisiana State Employees' Retirement System Teachers' Retirement System of Louisiana	**State Law** *Louisiana Revised Statues 11.2.I 266.1(B)* Each state public retirement or pension system, plan, or fund shall direct at least ten percent of the commissions on all trades of domestic equities in separately actively managed portfolios and shall direct at least ten percent of all trades of domestic investment grade fixed income investments in separately managed accounts through broker-dealers selected on a best bid and offer basis who have been incorporated and domiciled in or who have had their principal trading operations in Louisiana for at least two years.[115]	

STATES AND FUNDS	MANDATE, ENCOURAGE, OR ALLOW ETIs	DISCOURAGE ETIs
MARYLAND		
Maryland State Retirement and Pension System		**Board Investment Policy** **V. Economically Targeted Investments** It is the position of the Trustees that investments which are designed to promote or further some objective or special interest other than the exclusive interest of participants and their beneficiaries shall be rejected. Trustees are cognizant of the desire by interested parties to allocate a portion of SRPS' assets for specific or targeted investment programs. The decision to fund an ETI may occur only after the investment is deemed acceptable to the Fund exclusively on its economic investment merits.[116]
MASSACHUSETTS		
Massachusetts Pension Reserves Investment Management Board	**Board Investment Policy** **21. Economically Targeted Investment Policy** In cases where investment characteristics, including returns, risk, liquidity, compliance with allocation policy, and others, are equal, PRIM will favor those investments that have a substantial, direct and measurable benefit to the economy of the Commonwealth.[117] **State Law** *Massachusetts General Laws 32.23.2A(h)* Subject to the approval or ratification of the PRIM board, the executive director shall invest and reinvest such funds held by such board to the extent not required for current disbursements, as much as reasonably possible to benefit and expand the economic climate within the commonwealth so long as such is consistent with sound investment policy and the other requirements of this section.[118]	
MICHIGAN		
State of Michigan Retirement Systems	**State Law** *Michigan Compiled Laws 38.1133.3(e)* Give appropriate consideration to investments that would enhance the general welfare of this state and its citizens if those investments offer the safety and rate of return comparable to other investments permitted under this act and available to the investment fiduciary at the time the investment decision is made.[119]	

STATES AND FUNDS	MANDATE, ENCOURAGE, OR ALLOW ETIs	DISCOURAGE ETIs
MISSOURI		
Missouri State Employees' Retirement System	**State Law** *Missouri Revised Statutes 105.688 (5)* Give appropriate consideration to investments which would enhance the general welfare of this state and its citizens if those investments offer the safety and rate of return comparable to other investments available to the investment fiduciary at the time the investment decision is made.[120]	**Board Investment Policy** *MOSERS Governance Policy 17.* Regarding limitations on delegated authority, the Executive Director may not allow the CIO to make investments that are economically or socially targeted (ETIs or STIs)... The fiduciary principles of prudence and exclusive interest of participants will not be abrogated or modified in order to increase the attractiveness of ETIs or STIs... All participation should be voluntary on the part of the System and should not stem from a legal or policy mandate.[121]
MONTANA		
Montana Board of Investments	**State Law** *Montana Code Annotated 17.6.201.3(a) Unified Investment program* This section does not prevent investment in any business activity in Montana, including activities that continue existing jobs or create new jobs in Montana. (b) The board is urged under the prudent expert principle to invest up to 3% of retirement funds in venture capital companies. Whenever possible, preference should be given to investments in those venture capital companies that demonstrate an interest in making investments in Montana.[122]	
NEBRASKA		
Nebraska Investment Council		**State Law** *72-1239.01.3 Nebraska Investment Council* No assets of the retirement systems or the Nebraska educational savings plan trust shall be invested or reinvested if the sole or primary investment objective is for economic development or social purposes or objectives.[123]
NEW HAMPSHIRE		
New Hampshire Retirement System		**Board Investment Policy** *II. Investment Oversight Considerations* Asset managers and other investment-related service providers or opportunities shall be evaluated and utilized based on the intrinsic merits of the situation and not based on other external factors including but not limited to a social investing focus or economically-targeted objectives.[124]

STATES AND FUNDS	MANDATE, ENCOURAGE, OR ALLOW ETIs	DISCOURAGE ETIs
NEW YORK		
New York City Employees' Retirement System	**Board Investment Policy** *Economically Targeted Investing Policy* ETIs may cross a variety of asset classes, where practical and consistent with the standards in this and other policies. The System will seek to achieve a target allocation of 2% of assets to ETIs.[125]	
New York State Common Retirement Fund	**State Law** *N.Y. RSS. LAW § 423-b* The comptroller is hereby authorized to establish within the common retirement fund a New York state venture capital program for the purpose of investing in qualified businesses… The comptroller is authorized to invest up to two hundred fifty million dollars of assets of the common retirement fund to carry out the purposes of this section. The comptroller shall, to the maximum extent practicable, insure that the geographic distribution of investments in the program is in proportion to the state population.[126]	
NORTH CAROLINA		
North Carolina Retirement System	**Investment Board Policy** *Investment Policy: Private Equity Program's Innovation Fund* The Innovation Fund, a subset of the Private Equity Investment Program ("PEIP"), is an Economically Targeted Investment ("ETI") fund that is authorized to commit up to $250 million over a period of three to five years in investment opportunities with significant operations in, or significant connections with North Carolina.[127] **State Law** **§ 147-69.7.(5)** May consider benefits created by an investment in addition to investment return only if the Treasurer determines that the investment providing these collateral benefits would be prudent even without collateral benefits.[128]	
NORTH DAKOTA		
North Dakota Retirement and Investment Office	**Board Investment Policy** *Investment Policy* Where investment characteristics, including yield, risk, and liquidity are equivalent, the Board's policy favors investments which will have a positive impact on the economy of North Dakota.[129]	**Board Investment Policy** *Investment Policy* Economically targeted investing is prohibited unless the investment meets the Exclusive Benefit Rule.[130]

STATES AND FUNDS	MANDATE, ENCOURAGE, OR ALLOW ETIs	DISCOURAGE ETIs
OHIO		
Ohio Public Employees' Retirement System School Employees' Retirement System of Ohio	**State Law** *Ohio Revised Code 145.11/3309.15 Investment powers and fiduciary duties of board* In exercising its fiduciary responsibility with respect to the investment of the funds, it shall be the intent of the board to give consideration to investments that enhance the general welfare of the state and its citizens where the investments offer quality, return, and safety comparable to other investments currently available to the board.[131]	
OREGON		
Oregon Investment Council	**State Law** *Oregon Revised Statutes § 293.733 Venture Capital Investments* In making and implementing investment decisions related to venture capital, the Oregon Investment Council and the investment officer have a duty to look first at Oregon opportunities for diversification unless, under the circumstances, it is not prudent to do so. At any given time, the council shall have at least $100 million in venture capital investments in Oregon unless, under the circumstances, it is not prudent to do so.[132]	
PENNSYLVANIA		
Pennsylvania State Employees' Retirement System	**Board Investment Policy** *IV.A. Board of Trustees* The Board may, when possible and consistent with its fiduciary duties imposed by law, including its obligation to invest and manage the Fund for the exclusive benefit of the members of the System, consider whether an investment in any project or business enhances and promotes the general welfare of the Commonwealth and its citizens. Where investment characteristics, including yield, risk, and liquidity, are equivalent, the Board's policy favors investments that will have a positive impact on the economy of Pennsylvania.[133]	

STATES AND FUNDS	MANDATE, ENCOURAGE, OR ALLOW ETIs	DISCOURAGE ETIs
RHODE ISLAND		
Rhode Island State Investment Commission	**Board Investment Policy** *Statement of Investment Policy for Economically Targeted Investing* "The SIC Board has developed a Statement of Investment Policy related to ETIs, allowing up to two-percent ($135 million) of total pension funds under investment to be dedicated to targeted investments. The SIC is authorized to invest in a variety of asset classes that produce returns commensurate with other non-targeted investments, while providing auxiliary economic benefits to the State of Rhode Island."[134] **State Law** *Rhode Island General Laws § 35-10-13 Reinvestments directed at job retention and creation* The commission is specifically authorized to invest state funds or pension funds in investments which are intended to retain or create jobs in the New England region, but with priority given among the investments to the retention and creation of jobs in the state of Rhode Island ... provided, that the total amount of all these loans or investments do not exceed at the time of making the loan and/or investment five percent (5%) of the total funds which are under the jurisdiction of the commission.[135]	
SOUTH CAROLINA		
South Carolina Retirement System Investment Commission		**State Law** *South Carolina Code of Laws 9.16.50 (5)* May consider benefits created by an investment in addition to investment return only if the commission determines that the investment providing these collateral benefits would be prudent even without the collateral benefits.[136]
SOUTH DAKOTA		
South Dakota Retirement System		**State Law** *South Dakota Codified Laws 3.12.117* The assets of the system may not be used as venture capital, nor may the assets of the system be managed in any manner for the purposes of social investment. The State Investment Council shall invest member trust funds in a manner that is solely designed to provide for the exclusive benefit of the members and benefit recipients of the system.[137]

STATES AND FUNDS	MANDATE, ENCOURAGE, OR ALLOW ETIs	DISCOURAGE ETIs
TENNESSEE		
Tennessee Consolidated Retirement System	**Board Investment Policy** *Investment Criteria* The Board and the Investment Staff are aware of the desirability of investing within the state whenever quality, risk, diversification and potential return are equal to or greater than that available on like investments outside the state. The investment staff should encourage and be receptive to Tennessee financial proposals.[138]	
TEXAS		
Employees' Retirement System of Texas		**Board Investment Policy** *4.17 Economically Targeted Investments* The Board of Trustees has a fiduciary duty to manage and invest the assets of the Funds for the exclusive benefit of the Plan Beneficiaries. This fiduciary responsibility does not allow investment decisions to be made solely on non-economic or collateral considerations. Therefore, ETI's, like all investments, will be evaluated on their investment merits without consideration of the purpose of any secondary objectives.[139]
VERMONT		
Vermont Pension Investments Committee	**Board Investment Policy** *Economically Targeted Investment Policy* VPIC will consider investment opportunities that support economic and community benefits within the State of Vermont, provided that such economically targeted investments (ETIs) are consistent with VPIC obligations to the members and beneficiaries of its participating retirement systems and with the standard of care established by the prudent investor rule.[140]	
WASHINGTON		
Washington State Investment Board	**Board Investment Policy** *Economically Targeted Investments* The WSIB believes that the state of Washington remains an excellent place in which to invest a portion of the trust funds under management by the Board, and in fact the Board has previously invested a significant amount of capital in Washington-based investments through its real estate, private equity, fixed income, and public equity programs. The Board will continue to seek quality investment opportunities within the state in accordance with its established policies, statutory mandates, and fiduciary duty.[141]	

STATES AND FUNDS	MANDATE, ENCOURAGE, OR ALLOW ETIs	DISCOURAGE ETIs
WEST VIRGINIA		
West Virginia Investment Management Board		**Board Investment Policy** *III. Investment Philosophy* Consistent with its fiduciary responsibilities and the concepts of Modern Portfolio Theory, the Board does not and will not systematically exclude or include any investments in companies, industries, countries, or geographic areas.[142]
WISCONSIN		
Wisconsin State Investment Board	**Board Investment Policy** *Wisconsin Private Debt and Private Equity Portfolios* The Wisconsin Private Debt Portfolio's objective is to invest funds of the Wisconsin Retirement System in business activities that provide market-rate returns consistent with SWIB's fiduciary responsibilities and also to contribute to Wisconsin's economy … Investments in the Wisconsin Private Equity Portfolio are individually authorized by the Trustees, but shall be monitored and managed in conjunction with the Wisconsin Private Debt Portfolio. Prior to investment, a private equity consultant hired by SWIB will review prospective investments and confirm that new investments meet a prudent investor standard.[143] **State Law** *Wisconsin Statute 25.17.70* No later than December 31 of every even-numbered year, submit to the governor and to the presiding officer of each house of the legislature a plan for making investments in this state. The purpose of the plan is to encourage the board to make the maximum amount of investments in this state.[144]	
WYOMING		
Wyoming Retirement System	**State Law** *Wyoming Statutes 9-3-440 (v)* May consider benefits created by an investment in addition to investment return only if the trustee determines that the investment providing these collateral benefits would be prudent even without the collateral benefits.[145]	

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