Addressing Impact Intentionality and Accountability in Fund Formation Documents: Trends and Challenges

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Impact Investing is the act of investing with the intent to measurably contribute positive social, economic, and/or environmental impacts while still achieving financial returns.[1] The underlying concepts to Impact Investing have been part of investment ethos for over one hundred years, and socially responsible investing for even longer. Socially responsible investments took on a negative screening aspect in developed countries, particularly the US, in the Vietnam Era, amidst the protests over defense spending.[2] In the 1970s and 1980s, socially responsible investors began including environmental, social, and corporate governance (ESG) requirements, as opposed to just negative screening.

Today, however, socially-conscious investing can be categorized more precisely – from socially responsible (negative screening and/or including ESGs) to Impact Investing, which requires three elements: intent, contribution, and measurable improvement.[3]

Intent separates both socially conscious and impact investors apart from traditional investors. Investments are chosen with the intent to achieve a social or environmental goal. Contribution, as recently defined by the International Finance Corporation (IFC), is the difference the investor makes to the portfolio company or the market. The investor provides value addition to positively affect portfolio company activities – quantitatively or qualitatively – in ways that cause

a positive difference in social and environmental outcomes.[4] Finally, Measurement allows investors to make decisions based on the outcomes affected by the investment by providing tangible analysis.[5]

Impact investors must make express the intentionality of the impact and institute the mechanisms for accountability. This article addresses the practicalities and challenges of codifying intent, contribution, and measurement into fund formation documents.

Structuring the Fund: Fund Formation Documents to Address, Monitor, and Evaluate Impact

Fund formation documents can vary, but the essential items will likely include a resolution from the sponsor's board, private placement memo, term sheet, and associative document such as a limited liability company agreement or a limited partnership agreement. Each of these provides an opportunity to describe the fund's intent, contribution, and measurement mechanism.

A resolution from the Board of Directors of the sponsor of the fund is one way to authorize both the creation of the fund, and the form and manner of participation by the institution creating such a fund. The resolution provides an opportunity for the architects of the fund to communicate the intent and expectation of the impact to be achieved by the fund. Such a resolution might include instructions by phase. For example, prior to fund launch, the Board might require the fund team create a theory of change. During the holding period, the Board might require annual surveys against specific metrics. Finally, during harvest, the Board might require exit surveys to assess the result of the intended impact, and an assessment on the buyer of the portfolio company and its potential for ongoing impact.

1. Modified from IFC definition in its Guide to Investing for Impact: Operating Principles for Impact Management, Oct. 2018 at 1.
2. https://www.nytimes.com/1985/04/13/nyregion/protests-at-columbia-students-and-issues-have-changed-since-the-60-s.html; accessed August 1, 2019
3. Creating Impact: The Promise of Impact Investing, IFC, April 2019 at 3.
4. *Id.*, at 3.
5. *Id.*, at 10.

The private placement memorandum (PPM) includes the terms of the fund but also, critically to this discussion, the investment guidelines. Investment guidelines are common to fund formation documents – whether a socially conscious investment or not. These guidelines can include anything from geographic to sector restrictions and combinations thereof. To be an Impact Investment fund these guidelines must include the impact intent. Here, the fund architect will put down in hard figures the fund's intent to improve a particular social outcome, in specific measurable metrics, for example number of jobs, number of women hired, or number of health services provided.

The PPM also provides the opportunity to propose what the contribution will be. A credible impact investment thesis will postulate that, but for the contribution, a different (and lesser) outcome would occur. For example, for an investment in a financial services aggregation company, the PPM could outline how the financial contribution will enable the company to sell more products and services, with higher margins, tying that success specifically to the investment. Finally, measurement – what indices or factors will be tracked – should also be addressed in the PPM, as setting up that intention at the outset provides impetus to the investment team to search out investees that are amenable to measurement and will benefit from the intended impact.

The term sheet is where most negotiating with investors will occur, and therefore provides the most potential for slippage in the impact goals. It is critical to capture the same intent, contribution, and measurement indices promised in the PPM here in the term sheet. The challenge is that The fund creator must prevent erosion of the intent, contribution, and measurement goals outlined in the PPM as a fallout of such negotiations.

The investment agreement – which may be a Shareholders' Agreement, a Limited Partnership Agreement, a Limited Liability Company Agreement, or other – is the most critical tool in framing the impact of the fund. Here, the promises and expectations of the PPM and the term sheet are realized and set with authority, instructing the investment team and shaping the investments. The investment agreement must include the investment intent, the contribution that will be made, and the periodic measurements required to demonstrably link the contribution to the intent and therefore the impact.

Emerging Trends: Tools for Measuring Impact

Measurable metrics are critical to measuring impact. The Sustainable Development Goals (SDGs), a collection of 17 global goals set by the United Nations General Assembly in 2015 for the year 2030 are nearly industry standard for impact measurement and analysis. They are broad enough to allow Funds to link to almost any goal to best reflect the fund's impact strategy. To measure the impact on the SDGS though, one must have a tool. It is reasonable not every tool available to the industry will be useful to every kind of Fund. The following tools are useful in a variety of settings.

Small Enterprise Assistance Fund's (SEAF) Gender Equality Scorecard© (GES) is a proprietary tool SEAF uses to assess women's economic empowerment and gender equality within individual investment opportunities and portfolio companies for select SEAF funds. This rating system is structured around six gender equality vectors: pay equity, workforce participation, leadership and governance, benefits and professional development, workplace environment, and women-powered value chains.

SEAF uses the GES© for multiple purposes. First, as a screening tool to identify companies already demonstrating a commitment to gender equality. Second, as a tool to assess portfolio companies' level of demonstrated gender equality in order to improve it over the investment hold period, as a value creation activity. Third, it provides a guideline to develop best practices in the implementation of gender improvement plans across the underlying parameters of each gender equality vectors. Finally, SEAF leverages the data derived from the tool as it is applied across its gender lens portfolio to analyze the impact of improving gender equality on increasing investment returns for investors.

Other impact investors also use scorecards, but adaptable to a variety of effects. For example, Actis uses a six-step analysis, taking the intentionality, then assigning subjective numerical assessments on how much effect there will be, on who, the actual contribution, and factoring against risk and whether the impact is core, ancillary or peripheral.[6] EQ uses a scoring system to calculate impact by comparing how much of the impact reported by the portfolio company can be directly linked to the amount invested, using the SDGs to define the impact itself.[7] Impact Management Project, provides excel templates designed to classify the impact of investment products.[8] The advantage to each of these approaches, similar to GES©, is to have objective criteria to compare across investments and funds.

As IFC notes in its introduction to the Operating Principles for impact management, there exists little common discipline for how to manage investments for impact. Accordingly, IFC, in consultation with impact asset managers, asset owners, asset allocators, development banks and financial institutions developed

6. https://www.act.is/media/2336/actis-impact-score_-white-paper_low-res.pdf; accessed August 1, 2019
7. https://eqinvestors.co.uk/wp-content/uploads/2018/09/EQ-Positive-Impact-Report-2018.pdf; accessed August 1, 2019
8. https://impactmanagementproject.com/; accessed August 1, 2019

IFC's Operating Principles to establish "a common discipline and market consensus around the management of investments for impact and help shape and develop this market."[9] The Principles outline mechanisms for architects to have strategic intent, structure the fund, manage its portfolio, measure impact at exit, and finally have that impact independently verified.[10]

> "Different investors will often have their own reporting requirements. Working with investors to harmonize the kind of reporting they can expect will make successful and timely reporting on both financials and impact easier for your portfolio companies and investment team."

Challenges to Including Intentionality, Contribution, and Measurement in Fund Formation Documents

Challenges to including intention, contribution and measurement in formation documents lie in the tension between investor needs and realistic expectations for portfolio companies. Investors require protections for the financial interests and their own reporting requirements to their boards or directors. At the same time, portfolio companies simply exist in unpredictable environments, and overly onerous expectations will hamper their success.

Investors with the capital necessary to invest in today's impact investment funds are frequently institutional actors, which may face regulatory restrictions. For example, pension funds have the resources, but also have strict investment restrictions (reasonably so) in order to protect their assets from risk. An impact investment fund is inherently focused on not just the financial return but also the social and environmental returns, and inherently investing in higher risk investees. As such, meeting those needs in conjunction with keeping impact a center focus is a challenge, which may require creative solutions, such as placing the fund in a particular jurisdiction, or setting internal controls. Additionally, different investors will often have their own reporting requirements. Working with investors to harmonize the kind of reporting they can expect will make successful and timely reporting on both financials and impact easier for your portfolio companies and investment team.

One current point of discussion in the industry is how much of the impact obligation is appropriate to include in the investment agreement with the portfolio company. While this article generally addresses fund formation documents, this concept warrants inclusion, as the directive to instruct investees should be found in the fund formation documents to ensure consistent expectations. Reporting requirements are common and should not be designed to be onerous, but to ensure the investee is aware of the intent of the Fund. The equity or debt agreement with the investee should include specific metrics at the outset of the relationship. While the specific intent of the Fund may not exhaustively cover the potential impact of a portfolio company, building that intent into the portfolio company documentation should improve the collaborative nature of the relationship between the Fund's investment team and the portfolio company's leadership.

It is not practical to impose financial penalties on the portfolio company for a failure to reach a social or environmental metric. However, tying financial incentives for the investment team of the fund to impact achievement thresholds is a realistic mechanism. In this manner, funds which actively provide investees with the right potential, provide the proper guidance, and set reasonable impact goals will be further incentivized to achieve the impact – without penalty to the portfolio company for existing in an unpredictable environment.

Conclusion

Codifying intent, contribution, measurement into fund formation documents is critical to creating an effective Impact Investment fund. The PPM, term sheet, and investment agreement are each building blocks in a cohesive approach to investment, informing both the portfolio company and the investment team of the specific intent which will be measured. Challenges lie in the tension between investor needs, realistic expectations for portfolio companies and practical implementation of a successful fund. However, Impact Investment is critical to achieving real improvement in the conditions of emerging markets, and can only be successful where the fund manager keeps the intent, contribution, and measurement as equal priorities to financial returns.

About the Author

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9. https://www.ifc.org/wps/wcm/connect/76e6607a-11a4-4ae8-a36c-7116b3d9dab3/Impactprinciples_booklet_FINAL_web_4-12-19.pdf?MOD=AJPERES&CVID=mGNOa3Q; accessed August 1, 2019
10. Impact+Investing_Principles_FINAL_4-25-19_footnote+change_web.pdf; accessed August 1, 2019