IQEQ TIMEPARTNERS Hogan Lovells

Setting up an impact fund

YOUR ONE-STOP GUIDE

August 2022

Introduction

According to the IFC's latest estimate of the global market, $2.3 trillion was being invested for impact in 2020—a figure that has only increased since.

Changes in the international regulatory landscape, together with the COVID-19 pandemic, have accelerated investors' interest in sustainable investments alongside their awareness of global issues like climate change, social inequality, and ethical governance.

While impact investing is nothing new, the maturity of the market has been steadily picking up speed since the term was coined in 2007. We are seeing consistent growth by any metric: the volumes of capital deployed, the sophistication of impact measurement, and the diversity of stakeholders involved.

The value proposition behind impact investing is undeniably exciting, with far-reaching ramifications. The GIIN (Global Impact Investing Network) envisions a future in which social and environmental considerations are woven into the fabric of investment decisions by default—and while we aren't there yet, impact investments are an increasingly common part of a robust overall strategy.

That said, the rapid rate of change has put increasing pressure on organisations to provide more transparency around ESG and impact reporting. Establishing a solid base of knowledge and a consistent reporting framework has become a top priority for alternative asset managers, corporate entities, and private investors.

What qualifies as an impact investment? How can we—and, indeed, how should we—quantify our impact? For many years, the answers to these questions were decidedly ambiguous. While there is currently no universally accepted standard of measurement, we see the evolution of meaningful frameworks to guide investors and keep firms accountable.

In collaboration with our dedicated partners at Hogan Lovells and Time Partners, we created this guide to help shed light on this ambiguity and collate our core knowledge on the subject of impact investing. We hope this guide will provide valuable context and a much-needed guidepost for firms, asset managers, and investors looking to engage in emerging impact opportunities.

Ultimately, we believe that financial markets will be central in supporting solutions to critical problems facing our world. We are honoured to be active participants in shaping our common future, and we hope this guide empowers our clients to proceed confidently toward the same objective.

Justin Partington
Group Head of Fund and Asset Managers,
IQ-EQ

The History of Impact Investing

Believe it or not, impact investing has a long history that is deeply entwined with some of the world's most widely practised religions. The Bible and the Qur'an both established guidelines for using money ethically and for good purposes.

We can trace the roots of impact investing in its modern form back to the eighteenth century, when religious groups like the Quakers and the Methodists sought to align their investments with their spiritual beliefs. These groups forbade investments in slavery, war, smuggling, or "sin industries" like alcohol, tobacco, or gambling—ultimately, any practice that countered their values.

In the 1960s, socially responsible investing gained momentum with disinvestment campaigns surrounding opposition to the Vietnam War and apartheid in South Africa. The foundation of the socially responsible investment (SRI) fund industry was laid in the second half of the 20th century, when investors aligned around shared concerns like war and human rights. Today, more common issues include environmental, social, and corporate governance (ESG).

In 2005, the UNEP FI Freshfields Report demonstrated that ESG issues are relevant for financial valuation and therefore the fiduciary duty of institutional investors. This finding ultimately led to the formation of the United Nations Principles for Responsible Investment (PRI) in 2006. These principles were released to formalise global conventions around impact investing—a conversation that continues today.

The United Nations Principles for Responsible Investment (PRI) are:

1. We will incorporate ESG issues into investment analysis and decision-making processes
2. We will be active owners and incorporate ESG issues into our ownership policies and practices
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest
4. We will promote acceptance and implementation of the Principles within the investment industry
5. We will work together to enhance our effectiveness in implementing the Principles
6. We will each report on our activities and progress towards implementing the Principles

At present, there are 3800+ signatories to the PRI, accounting for about $120tn of Assets under Management.

The concept of formally incorporating environmental and social awareness into investing without sacrificing profitability was introduced during a conference of experts at the Rockefeller Foundation in 2007.

What is Impact Investing?

The Global Impact Investing Network (GIIN) defines impact investments as "investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return." Impact investments can be made in both emerging and developed markets and target a range of returns from below market-to-market rate depending on investors' strategic goals.

The growing impact investment market provides capital to address the world's most pressing challenges in sectors like:

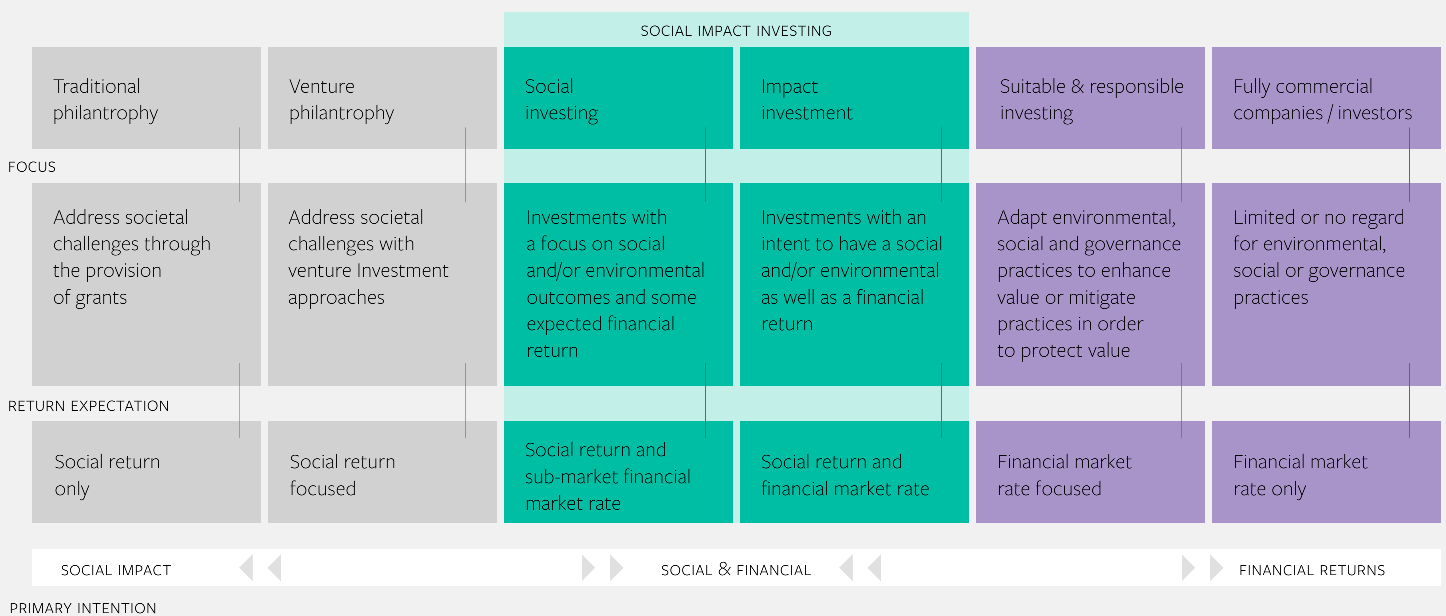
- Sustainable agriculture
- Renewable energy
- Conservation
- Microfinance
- Affordable basic services (housing, healthcare, education, etc.)

In April 2019, the GIIN published its Core Characteristics of Impact Investing to complement their definition and clarify how investors should approach impact investments.

Those four characteristics are:

1. INTENTIONALITY: An investor's intention to have a positive social or environmental impact through investments
2. USE EVIDENCE AND IMPACT DATA IN INVESTMENT DESIGN: No solid investment strategy is built on hunches. Impact investing should leverage evidence and data where available to drive intelligent investment design that will help steer toward profitable investments and broader social/environmental benefits
3. MANAGE IMPACT PERFORMANCE: Investments must be managed towards their intended impact, which necessitates feedback loops and communicating performance data to stakeholders in the investment chain
4. CONTRIBUTE TO THE GROWTH OF THE INDUSTRY: Investors should use shared industry terms, conventions, and indicators to describe impact strategies, goals, and performance. They should also share learnings to enable others to learn from their experience regarding which investments succeed in creating social and environmental benefit

The spectrum of capital: Moving towards greater impact



Source: OECD, based on earlier verson from various organisations.

Impact investing vs socially responsible investing (SRI) — What's the difference?

SRI typically applies a set of screens to publicly listed securities; for example, a mutual fund that avoids investments in firearms. It is generally a passive, "do no harm" approach to investing.

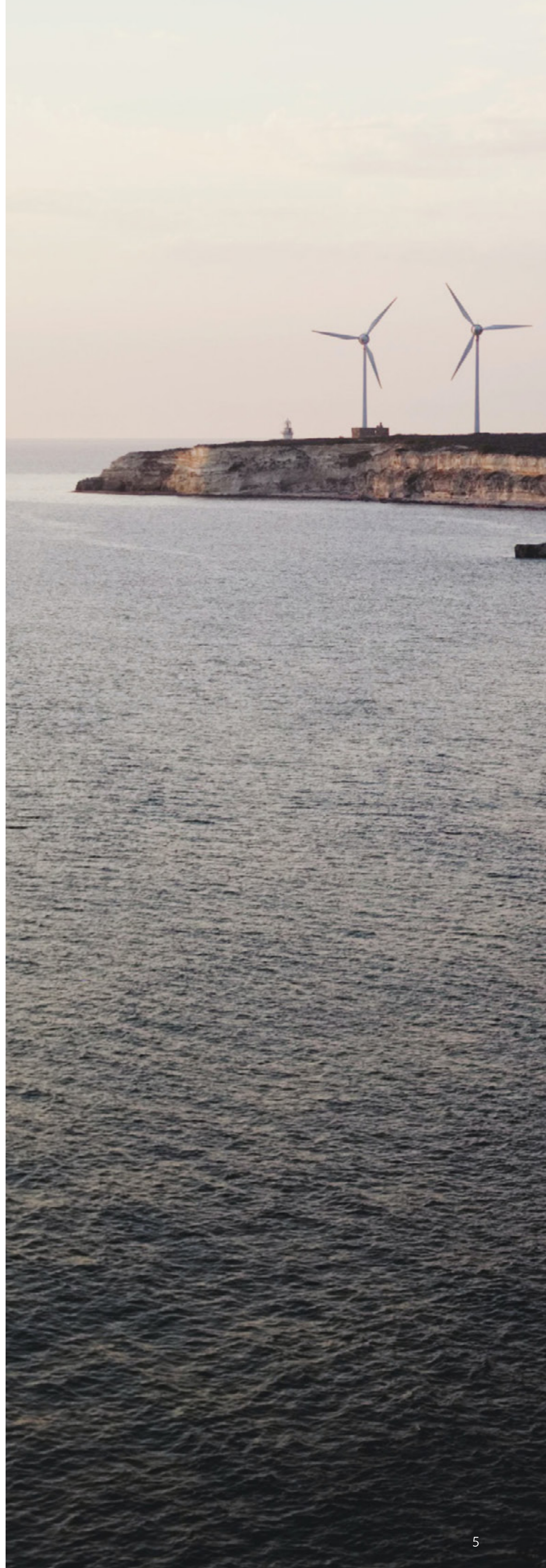
Impact investing actively seeks to invest in companies or projects with the potential to initiate social or environmental benefits, as well as to measure and report their impact.

Impact Investment Best Practices:

- Establish social and environmental objectives, and share them with relevant stakeholders
- Set performance targets related to those objectives using standardised metrics
- Monitor and manage investees' performance against these targets
- Report to stakeholders on social and environmental impact

Impact Investment Examples:

- A private investor who invests in companies that produce sources of renewable energy because they believe this investment will benefit the environment over the long term
- Investing in an "impact portfolio" with lower carbon emissions per dollar of revenue than alternative portfolios. These portfolios usually exclude companies involved in tobacco, weapons, thermal coal, and other sectors seen as damaging to society or the environment
- Banks investing in nonprofit lenders that loan money to nonprofits and startup businesses with ESG-driven missions that are not able to secure traditional financing



Administration and Reporting

Key parties to involve

When setting up an impact investment fund, be sure to involve these key parties:

- Investment manager
- Investors
- Lawyers
- Bank
- Reporting accountants
- Depositary (if applicable)
- ESG consultants
- Technology providers
- Auditors
- Independent verifiers
- Portfolio company
- Local communities
- Regulators

How to create and measure impact

Impact measurement is one of the more challenging objectives in impact investing. At present, there is no single established global standard—but, guidelines have emerged that can help direct impact investors toward meaningful reporting metrics.

Impact measurement and management includes identifying and weighing the positive and negative effects an investment action may have on society and the planet. It also includes identifying strategies to mitigate negatives and maximise positives in alignment with an investment vehicle's stated goals.

Some of the most relevant sustainability frameworks

ESG criteria

ESG criteria are often used to measure an impact fund's effectiveness—but without widespread agreement on a standardised assessment, what does that mean? The answer can range from tracking specific ESG metrics (e.g. waste volume, water usage, or board diversity) to measuring how a company affects its stakeholders and society at large. The latter often goes beyond ESG metrics to broader, more complex assessments like how a company has improved access to clean drinking water or provided a higher standard of living for a marginalised group.

What is ESG?

ESG is a term that is often used interchangeably with impact investing, but their meanings differ. ESG (Environmental, Social, and Corporate Governance) criteria form a broad set of standards to evaluate an investment fund or firm's effectiveness in creating impact.

Four essential actions when using IRIS+

The IRIS+ System from the GIIN is one broadly recognised system for measuring impact. IRIS+ recommends starting with four essential actions:

1. SET GOALS AND EXPECTATIONS: Consider the effects aninvestment will likely have on society and the environment, and balance them against investor expectations for risk, return, liquidity, and impact. IRIS+ has laid out a thematic taxonomy to direct investors in setting impact goals, though the UN Sustainable Development Goals (SDGs) described below are also compatible with this framework.

2. DEFINE STRATEGIES: Consider which investment strategies align best with your portfolio, investment expertise, and investor demand. This phase should be strongly evidence-based and directly linked to quantifiable outcomes.

3. SELECT METRICS AND SET TARGETS: Use relevant metrics to establish targets, track performance, and gauge success. Impact metrics should strengthen the performance of a portfolio and investment strategy while helping guide investment decisions. IRIS+ includes a list of Core Metrics that may serve as key indicators depending on an investor's strategic goals.

4. MANAGE PERFORMANCE: This stage is about more than watching your established metrics. It's an iterative process of considering risks, returns, and impact to improve overall investment decision-making. Feedback from affected stakeholders is essential, as is disclosing understandable impact performance data.

Key performance indicators in IRIS+

Based on the Impact Management Project framework, IRIS+ divides each key performance indicator (KPI) or target outcome into specific dimensions:

- What: What outcomes occur in the measurement period?
- Who: Who experiences those outcomes?
- How much: How much of the outcome occurs? (Scale, depth, duration, etc.)
- Contribution: What is the enterprise's contribution to the outcome, accounting for results that would have occurred naturally?
- Risk: What is the risk to society and the planet if the impact does not occur as expected?

Suggested use for IRIS+: IRIS is ideal for finding a key metric to target; for example, tracking the percentage of greenhouse gas emissions avoided as a result of a fund's investment activity.

UN-defined SDGs

The UN's Sustainable Development Goals (SDGs) are another widely recognised method for standardising conversations around impact investing. In 2015, the UN created a list of 17 Sustainable Development Goals as part of its 2030 Agenda for Sustainable Development. The original objective was for governments to work together towards a common set of goals, but this framework has since been widely adopted by the investment community.

SDGs are core issues the UN has identified as critical to solve, so funds looking to target or create impact can often align themselves to one or more of these.

The 17 SDGs are:

1. No poverty
2. Zero hunger
3. Good health and well-being
4. Quality education
5. Gender equality
6. Clean water and sanitation
7. Affordable and clean energy
8. Decent work and economic growth
9. Industry, innovation, and infrastructure
10. Reduced inequalities
11. Sustainable cities and communities
12. Responsible consumption and production
13. Climate action
14. Life below water
15. Life on land
16. Peace, justice, and strong institutions
17. Partnerships for the goals

Suggested use for SDGs: You may wish to use the SDGs to direct your fund toward a specific problem, like climate change. They are especially useful in early stages of funding to attract investors with aligned interests.

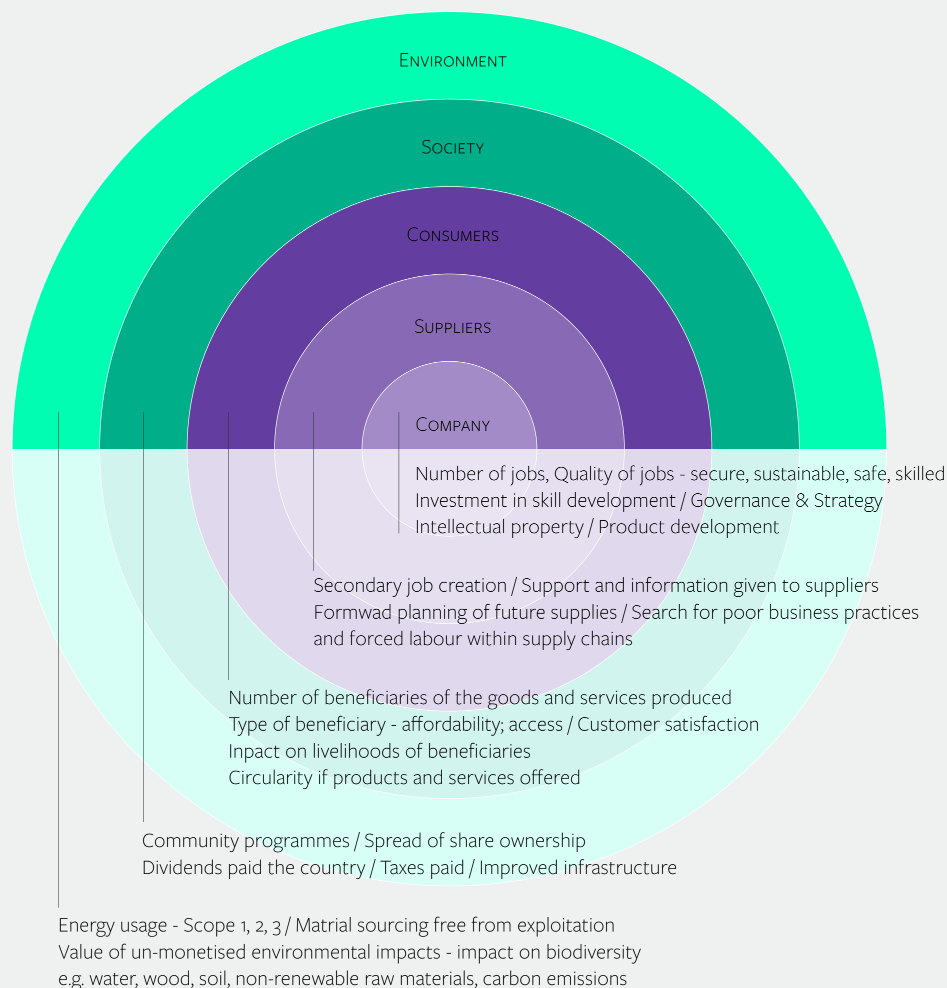
The External Rate of Return

The External Rate of Return (ERR) measures a company or investment's wider impact on society, the economy, and the environment. One group looking closely at the question of 'who experiences these outcomes?' (as posed by the IMP) is Time Partners, an independent investment advisory firm. The External Rate of Return (ERR) was developed by Time Partners in collaboration with the London School of Economics seeks to guide the reporting and measurement of all environmental, social, and economic impacts for any business or investment.

The ERR is designed to be a simple, holistic framework allowing companies, investors and third parties to track and report their activities across a range of parameters. The ERR has been adopted by individual companies and private equity firms to underpin their approaches to impact.

Broadly speaking, the framework looks at the impact of a company or investment across five areas:

- Company
- Suppliers
- Forward planning
- Customers
- Impact on livelihoods
- Circularity of products
- Society
- Dividends paid in-country
- Environment
- Material sourcing



The underlying philosophy of the framework is that the operations of any company have a ripple effect throughout these five areas. For example, a negative factor in the suppliers area will have a knock-on negative impact on the customers, society, and environment. In this way, the ERR considers all positive and negative impacts of a company across these five areas.

This is important when evaluating the impact of a company against its purpose. We may find that a company is causing more harm than good while setting out to achieve positive outcomes; even projects with the best intentions may give rise to local exploitation. One example is the creation of local jobs with the trade-off of environmental degradation. The ERR enables a more expansive view of a company's net societal contribution, using diversified impact metrics that are easy to understand and reflective of real (and often overlooked) business impacts, adapted for public engagement. By following the methodology proposed by the ERR, companies and the public at large can engage in ongoing dialogues about the overall impacts of a business.

Some of these often-overlooked metrics might include:

- Number of secondary jobs created through a multiplier effect
- Creation of intellectual property
- Profit sharing amongst employees

These metrics fall under the company header. Another example of overlooked metrics from the society area may be taxes paid. We know this can be a contentious issue for global technology giants; by looking at the taxes paid against the number of jobs and secondary jobs created annually, alongside the impact on livelihoods and beneficiaries, we can better evaluate the net social value of these companies. A high-level representation of the metrics is given above.

Time Partners applies the ERR approach to the SDGs, focusing on the global need to redress the overuse of natural resources and the underuse of human capital. Reporting how raw materials are obtained and the percentage of renewable materials and energy used, alongside the circularity of products or services offered, should lead us closer to meeting European Union (EU) objectives for a circular economy.

Suggested use for ERR: ERR is best used to measure and report on the holistic environmental impacts of the company overall; for example, net carbon emissions, renewable energy consumed as a percentage of the whole, etc. When seeking to invest to achieve measurable social and/or environmental impacts alongside a financial return, investors must measure and track metrics related to the core purpose of the investment. However, it is important to include a holistic view of how the company or investment will affect the company employees, suppliers, customers, society, and the environment.

Impact fund administration basics

Every investment fund or co-investment vehicle requires several basic components to initiate, and impact funds are no exception. Here are a few administration bases that impact fund managers should watch for.

Impact statement/mission

A well-crafted investment and impact statement distils a complex investment strategy into a simple, clear narrative supported by data and other measurable evidence.

Impact funds have a more significant hurdle to overcome in telling their stories than traditional funds do, so this step can be challenging. Fund managers should be clear from the outset on the intended impact of their fund and how they will communicate that impact to investors.

Questions fund managers should ask while creating a fund thesis:

- Impact funds have a more significant hurdle to overcome in telling their stories than traditional funds do, so this step can be challenging. Fund managers should be clear from the outset on the intended impact of their fund and how they will communicate that impact to investors.
- What need in the market does my investment thesis address?
- Is there evidence that this need exists? If so, what is the extent of that need?
- What underlying assumptions inform my thesis?
- Do the proposed sector of investment, deal size, and deal type suit existing market needs?
- Are the expected returns and exit strategies realistic and appropriate?
- Will the fund be unique in the marketplace? What will set it apart?
- What will make the fund attractive to investors?
- How does my impact strategy compare to others?

Your answers to these questions will influence critical fund management decisions, like which types of LPs to target and how to assemble your fund management team.

Align and build a strong ESMS

An ESMS is an Environmental Social Management System, or a set of policies, procedures, and tools to identify and manage a firm's exposure to the environmental and social risks of its clients/investees.

A strong ESMS will allow your strategy and mission to be clearly communicated to everyone in the business, driving impact firmwide. The ESMS should:

- State the firm's commitment to environmental and social risk management
- Describe procedures for identifying, assessing, and managing transactional risk
- Define the decision-making process
- Outline roles and responsibilities
- State documentation and recordkeeping requirements
- Guide transaction screening and due diligence
- Describe monitoring strategy for clients'/investees' ESG performance

Annual reporting

Every impact fund manager should provide an annual impact report to investors. This report can also be shared with portfolio companies (PCs), tracking your fund's success against your stated initiatives. Where have your actions been successful, and where has progress been made?

It may help to include an annual environmental and social report for each portfolio company. Most firms should plan to partner with an expert to produce these reports in a way that maximises investor understanding.

Also, consider which KPIs you are willing to track and inform your PCs early. These KPIs should centre around how the fund has created societal benefit.

First-time fund manager?
Download our First Time Fund Start-Up Guide.

Structuring issues for Impact Funds

This section of the IQ-EQ Impact Funds Guide was written by lawyers in the investment funds team at global law firm Hogan Lovells.

In one sense, the structuring issues that arise on the launch of a new impact investment fund are very much the same as those which arise on the launch of most alternative investment funds, namely:

- Where, and in what, will the fund be investing?
- Where will the fund be marketed? In particular, will the fund be marketed to investors in Europe? Will the fund be marketed to investors who are now wary about funds domiciled in places that have been featured on an inter-governmental blacklist?
- What legal form should the vehicle take (e.g. limited partnership, company etc)
- Where should the fund vehicle be domiciled?
- What legal form should the fund management entity take?
- Where should the fund management entity be domiciled?
- Will the management company be a "host" manager that is made available by a specialist provider such as IQ-EQ, or an entity that is owned and operated by the fund principals?

In considering most of the above issues/questions tax considerations will of course be very important. For example, a key objective with any fund structure is to ensure that the investors are not materially worse off than if they had invested directly into the underlying assets of the fund. However, tax efficiency should always be considered alongside other important factors.

There are however some important additional considerations to factor in when launching an impact fund, which may make a material difference to the recommended structure. These include:

- Will the fund be relying on Development Finance Institutions (DFIs) in order to achieve a viable fund size?
- Will the fund only be very small, with establishment and ongoing administration costs needing to be kept to an absolute minimum?
- Are the proposed fund economics broadly in line with the standard private equity model (i.e. 20% carried interest over an 8% hurdle) or will the fund waterfall adopt a different approach (e.g. with certain investors accepting a "first loss position" that cushions other investors in a downside scenario)?

We address each of these topics below.

Where, and in what, will the fund be investing?

It is critical to understand at the outset whether there are any tax, regulatory or other considerations that will drive the structuring of the vehicle. For example, it is increasingly common to see India-domiciled funds being used for funds that will focus their investments in India, and of course Mauritius has for many years being a popular jurisdiction for funds focused on Africa. For a long time Cayman has been a popular choice for Asia based managers investing across that region.

It is often possible to "mix and match", e.g. we have worked on several Africa funds that are domiciled in the Channel Islands but invest via (predominantly) Mauritius holding companies and SPVs, however the manner in which tax substance requirements are evolving is generally making such an approach less attractive in many cases and there can therefore be benefits (in terms of the robustness of the fund structure from a tax point of view) in having the fund, holding companies and SPVs located in the same jurisdiction (where reasonably possible, and subject to other considerations that may dictate a different approach, of course).

Where will the fund be marketed? In particular, will the fund be marketed to investors in Europe? Will the fund be marketed to investors who are now wary about funds domiciled in places that have been featured on an inter-governmental blacklist?

A key consideration relates to the impact of Alternative Investment Fund Managers Directive (AIFMD). A manager wishing to market a new impact fund on a widespread basis in Europe will usually find it very hard to navigate the plethora of national private placement rules (NPPRs) and may therefore prefer to access the so-called "marketing passport". However, subject to the exceptions noted below, this will require both the fund and the fund manager to be EU domiciled and to comply with AIFMD in full. For first time impact funds who are very unsure how much money they will raise, the costs of AIFMD compliance can be a real challenge. There are service providers such as IQ-EQ who can provide solutions in terms of acting as the regulated fund manager, lending their experience of compliance with the relevant rules, but the rules will still need to be complied with. One potential solution to this 'cost versus market access' conundrum lies in the availability of a special marketing passport for certain small managers under the European Venture Capital Fund (EuVECA) or the European Social Entrepreneurship Fund (EuSEF) regimes. These regimes offer (whilst still being afforded access to a pan-EU marketing passport) a much lighter touch regulation of the fund manager (and indirectly of the fund as well) provided that the fund complies with certain requirements; these relate principally to what the fund is permitted to invest in. In our experience many managers find the restrictions are too narrow, but it is always a good idea to check this at the outset in order to be sure whether these regimes could potentially apply to any proposed new impact fund.

What legal form should the vehicle take?

In our experience, the vast majority of impact funds are closed-ended and adopt the form of a traditional, private equity-style limited partnership ("GP/LP"). GP/LP funds are tried and tested structures in almost all the key jurisdictions and they offer significant flexibility to both managers of and investors in impact funds, for example, in relation to governance and sharing of economics. In jurisdictions where limited partnerships are not commonly seen, impact funds are usually set up in the form of a private investment company – while these usually work perfectly well, we tend to find that the need to comply with domestic company law rules can sometimes interfere with what the parties want commercially. In particular, it is typically easier to put in place more complex/flexible distribution provisions in a GP/LP structure, which can be attractive where there are investors with very different economic rights (e.g. where the philanthropic investors agree to cushion the other investors against losses up to an agreed amount, or agree to have their potential profit capped).

Where should the fund vehicle be domiciled?

If (for the reasons outlined above) an EU domicile is desirable, then Luxembourg is the most common choice in our experience, although we have seen Ireland being used more often in the last 2-3 years. The use of Ireland may increase now that is has revamped its legal regime for GP/LP funds to make it more user-friendly. If an EU domicile is not needed then the most commonly used jurisdictions are the Cayman Islands (for US and Asia based managers), the Channel Islands (for UK/European managers), the UK (for domestic social impact funds) and Mauritius (for Africa focused funds). We are also starting to see some Asia based managers using the new variable capital company ("VCC") structure in Singapore.

It may be possible to combine both an EU and a non-EU vehicle as part of a parallel fund structure, however this adds to cost and operational complexity and is often not suitable for smaller funds for that reason.

What legal form should the fund management entity take?

Investors in an impact fund are very likely to be agnostic about the form of management entity provided it is a reasonably mainstream choice that does not raise any red flags in terms of impeding transparency. They will want to know who the owners and managers are, and they are likely to want certain protections in the fund documents in relation to a change of control. This is especially true of DFI investors, who will expect tight controls over the ownership of the manager and also the distribution of the carried interest. However, the choice between a simple company and other commonly seen forms such as a limited liability partnership (LLP) is likely to be driven by tax and governance requirements that are internal to the management team and/or parent company.

Where should the fund management entity be domiciled?

As discussed above, there may be regulatory/EU market access requirements that necessitate an EU-domiciled management company. Absent any such considerations, it is usually best to use a jurisdiction that has a connection to the physical location of members of the senior management team due to the fact that, increasingly, the tax authorities around the world are introducing enhanced substance requirements and these are more easily satisfied if key personnel are physically present in the jurisdiction.

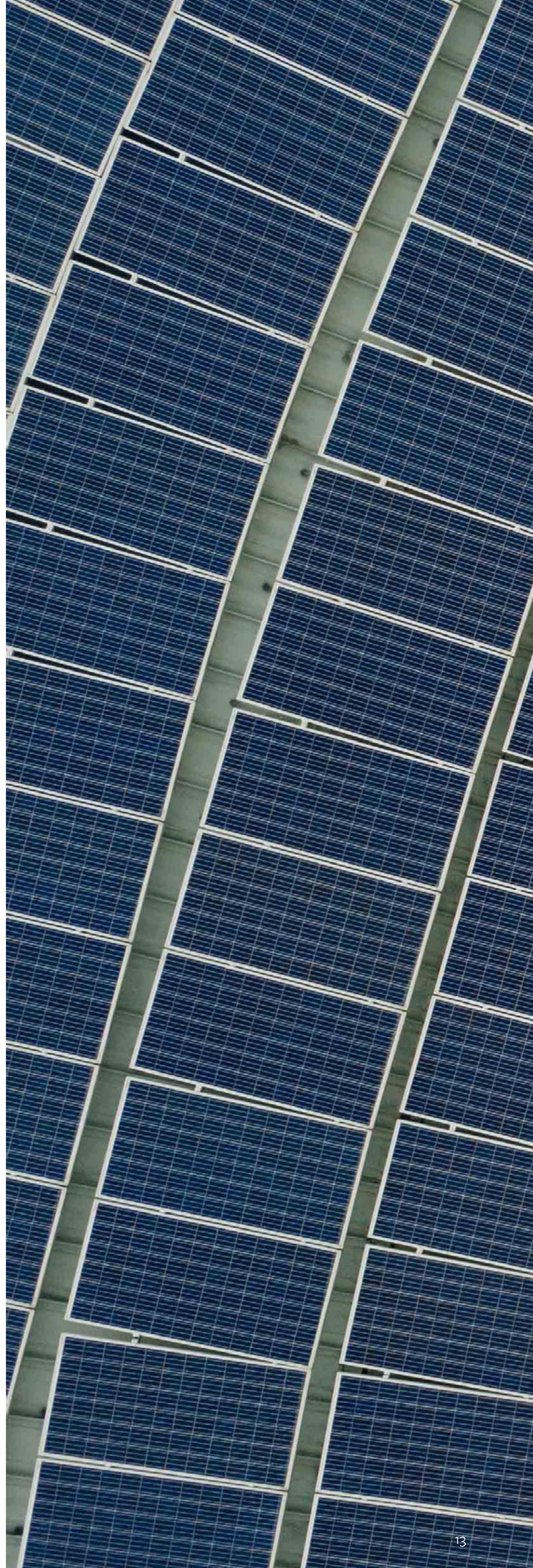
Will the management company be a "host" manager, or owned and operated by the fund principals?

The starting point for most entrepreneurs looking to launch a new impact funds business is that they will want to own and operate their own management company. In our experience, the reason for wanting/needing to work with a host manager typically arises in two cases. The first is where the fund and the management company need to be set up in a jurisdiction requiring substance and compliance expertise that the management team does not possess (for example, where an EU based manager is needed who must comply with all the AIFMD rules in order to access the pan-EU marketing passport).

The second is where the manager wants to reach a 1st closing on the fund before it will have its own regulatory licence to act as manager, in which case a "host" manager can step in for a short period (typically 6-12 months) to tide the manager over. Where there is a host manager, the team behind the creation of the fund are usually appointed in some form of advisory capacity, although note that for EU funds there are strict rules about whom a manager can delegate portfolio management to. In our experience, the presence of a host manager can add complexity when negotiating impact fund documents with DFI investors, however it is generally accepted that such arrangements may be unavoidable for start-up impact fund managers.

Are there different or additional considerations when setting up a co-investment fund in the impact sector?

A key initial question is whether all of the co-investors will already be investors in the main fund. The relevance of this is that, where all the co-investors are investors in the main fund and the main fund documentation provides for them to be informed about co-investment opportunities, it may be possible to conclude that there will not be any "marketing" of the co-investment vehicle – in which case concerns relating to accessing the AIFMD



marketing passport may fall away entirely, allowing the decision on the domicile for the co-investment fund to be based solely on other factors. However, as a general rule, it is easier (from a governance and operational perspective) to establish a co-investment fund in the same jurisdiction in which the main fund has been established.

What are the main types of vehicles that are used in the key jurisdictions for domiciling impact funds?

AUSTRALIA

- Venture Capital Limited Partnership (VCLP) – offers advantageous withholding tax treatment for non-Australian investors, but has prescriptive investment requirements
- Early Stage Venture Capital Limited Partnership (ESVCLP) – very similar in nature to the VCLP from a legal perspective, but offers nil tax on fund payments. Purely for investment in early stage companies
- Australian Unit Trust (AUT) – if the AUT qualifies as a 'managed investment trust' (MIT), it offers investors deemed capital account treatment on capital gains, and preferential withholding tax rates for non-Australian investors.

CAYMAN ISLAND

- Exempted limited partnership (ELP)

CHANNEL ISLANDS (JERSEY, GUERNSEY)

- Limited partnership established (in Jersey) as a ″Private Fund″ or an ″Expert Fund″, or (in Guernsey) as a ″Private Investment Fund″

IRELAND

- Investment limited partnership (″ILP″) – only recently introduced and looking to compete head-on with the Luxembourg SCSp
- Investment company with variable share capital (″ICAV″)

LUXEMBOURG

- Limited partnership - either the *société en commandite spéciale* (″SCSp″) which does not have its own legal personality and is designed to mirror the UK/Anglo Saxon model, or the *société en commandite simple* (″SCS″) which has its own legal personality ; most commonly we see the SCSp being used
- Partnership limited by shares (*société en commandite par actions* or ″SCA″), which has hybrid characteristics and can be helpful where you want certain features of a limited partnership but need a structure that is opaque (i.e. like a company) for tax purposes
- Investment company (*société anonyme*, or ″SA″), usually structured with variable share capital (*société d'investissement à capital variable* or ″SICAV″)

MAURITIUS

- Limited partnership
- Investment company

SINGAPORE

- Variable Capital Company or "VCC" – only recently introduced; it has separate legal personality, a variable capital structure and can consist of both open-ended and closed-end sub-funds

UNITED KINGDOM

- Private fund limited partnership (PFLP)

Regulation: Global Organising Bodies

There is just one global body to consider in impact investing: the International Finance Corporation (IFC) and its nine Impact Principles. The Impact Principles provide a framework for investors to ensure that impact considerations are integrated throughout the investment lifecycle. Systems can be adjusted to fit the needs of an organisation; the IFC does not prescribe specific impact measurement frameworks.

Instead, the Impact Principles were designed to be:

- Scalable
- Relevant to all types of impact investors
- Applicable to all asset types, sectors, and geographies
- Adopted at the corporate, line of business, fund, or investment vehicle level

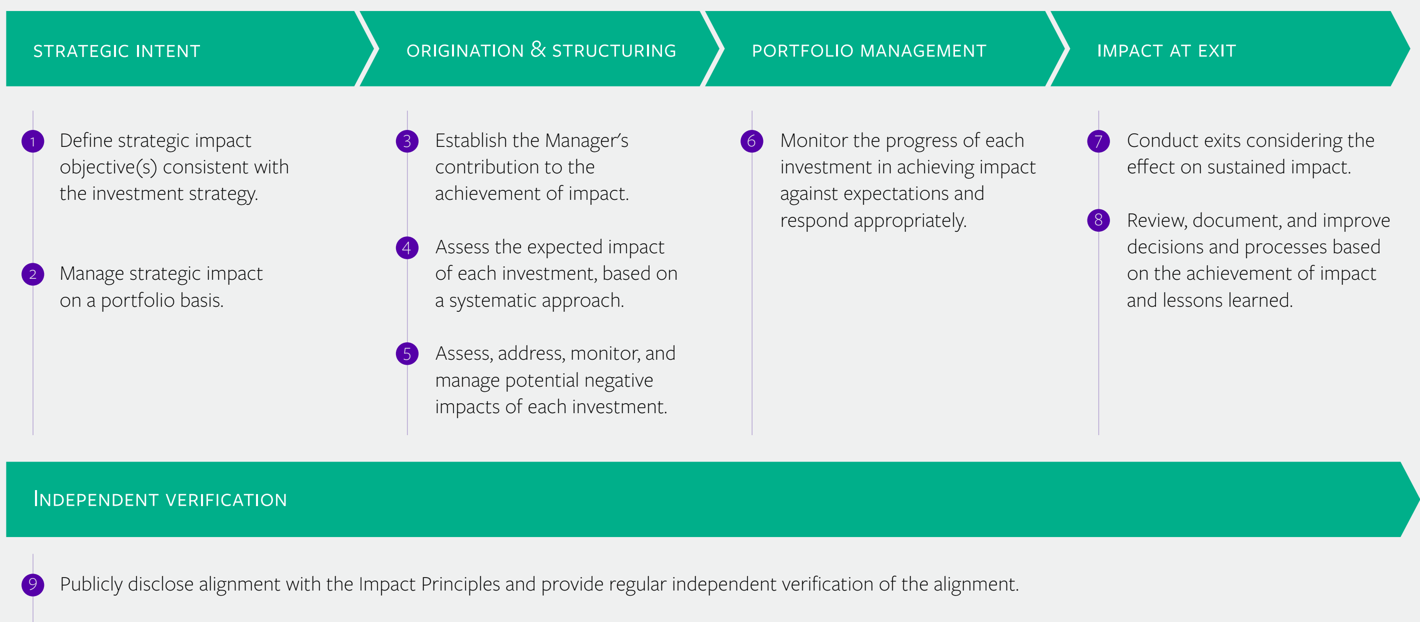
Asset managers may use the Impact Principles to give investors confidence, and asset owners and advisers may use them as a screening tool for impact investment opportunities. Outside of the IFC Impact Principles, there are very few globally recognised guidelines to direct impact investments. Many fund managers seek to align their investments to the UN's SDGs and/or use IRIS+ to measure and manage impact.

Regulatory considerations

Governments in the EU have encouraged capital flow toward projects that promote a more sustainable economy. Investors historically lacked sufficient information to compare sustainable investment options and measure them against their investment goals.

Against this backdrop, the Sustainable Finance Disclosure Regulation (SFDR) was implemented in 2021 to regulate impact investing. The SFDR was designed to ensure a level playing field by helping asset owners and investors compare and monitor the sustainability characteristics of investment funds through standardised sustainability disclosures.

At present, SFDR is very climate-focused, so most regulation is directed toward green initiatives, but these regulations are expected to expand.



SFDR at a glance:

- Article 6 strategies either integrate environmental, social, and governance (ESG) considerations into the investment decision-making process or explain why sustainability risk is not relevant
- Article 8 strategies promote social and/or environmental characteristics and may invest in sustainable assets or vehicles, but do not have sustainability as a core objective
- Article 9 strategies have a direct sustainable investment objective

If marketing your fund in the EU, ensure alignment with SFDR for Article 9 funds.

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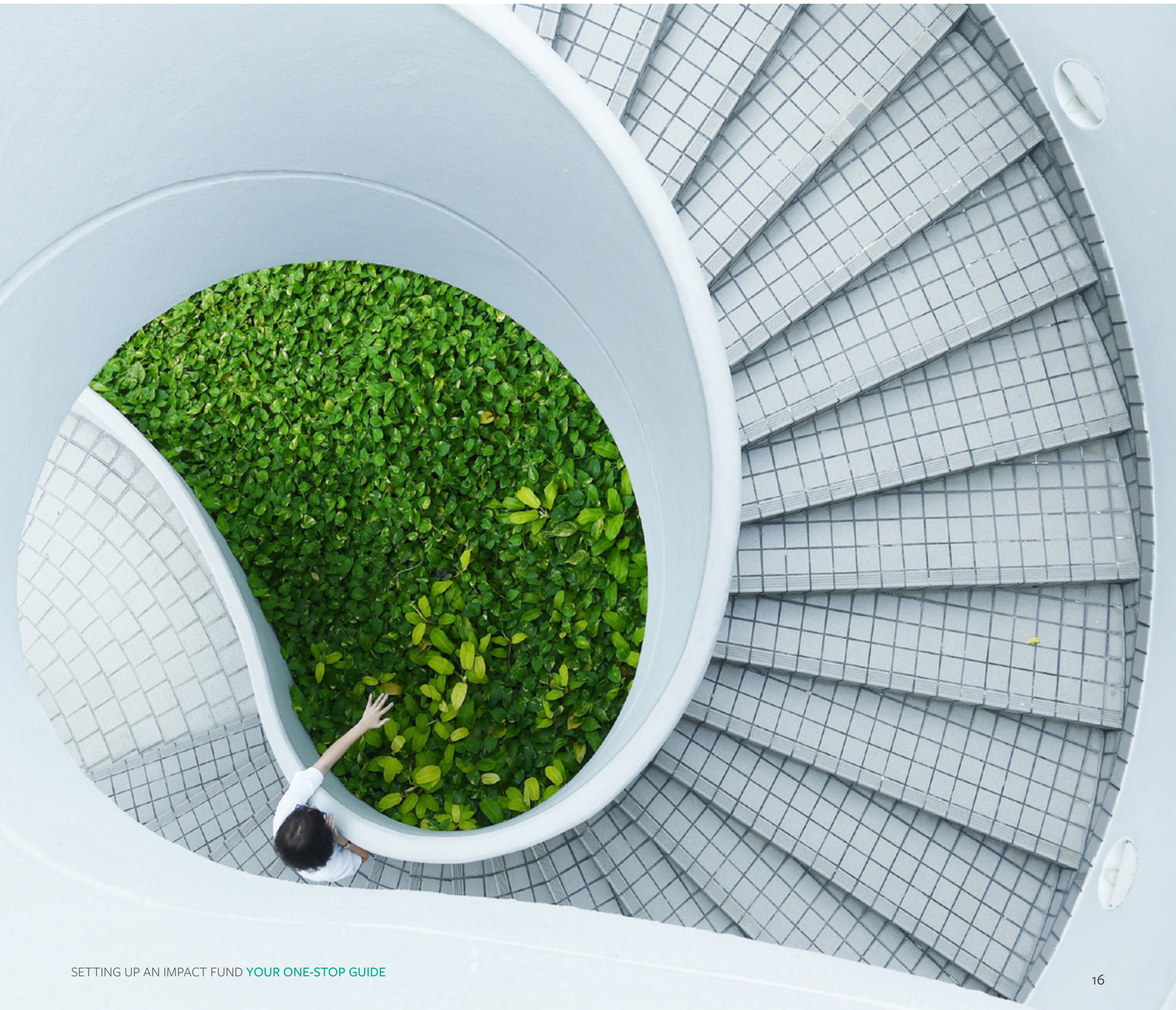
Additional regulations in the EU are planned as part of the EU Action Plan on Sustainable Finance. In the UK, the Financial Conduct Authority (FCA) has also made recent moves to help direct investors toward responsible ESG investment activity. One such move is the UK's Sustainability Disclosure Requirements (SDR), which will require reporting on sustainability risks, opportunities, and impacts. The global baseline sustainability reporting standards under development by the International Financial Reporting Standards (IFRS) Foundation's sustainability standards board will form the backbone of the SDR framework and any required corporate reporting.



Impact Fund Best Practices

Guidance from established impact fund managers, advisers, and family offices.

Create a substantial investment and impact thesis

According to the GIIN's Annual Impact Investor Survey, the number of impact funds increases every year. In this environment, it's all the more important for a fund to differentiate itself through a compelling investment and impact thesis. A clearly articulated thesis is coherent and rooted in evidence, stands out among competitors in the market, and can be distilled into a concise and persuasive pitch.

Fund design

LPs interviewed during the development of this guide agreed on one common reason fund managers fail to secure capital commitments in today's market: underestimating the importance of a robust design. Fund design includes the critical elements of fund structure:

- A balanced team that can execute for financial and impact returns
- A substantial deal flow pipeline that indicates the ability to find good deals and deploy capital
- Thoughtful consideration of details including terms, drivers of return, and opportunities to add value

Fund managers should consider how each of these elements may be characterised at the start of a fund's life, as well as how they may evolve alongside the fund.

We recommend fund managers to focus on one theme versus many. For example, an ocean fund, or climate fund, or food fund. Would avoid creating a fund that is more general in nature, as it makes it harder for investors to categorize the fund and thus, they are less likely to make an investment.

Michael Pellman Rowland
Baseline Wealth

Build a strong team

Build a strong team of advisers to help with market analysis, due diligence, and other nuanced activities. This is particularly important for first-time fund managers, or managers who are newly moving into the impact space. Only a highly qualified team can effectively implement a fund's strategy and produce financial returns and impact for its investors. Founders and leaders of successful funds frequently come from varied backgrounds and have expertise in both the social and private sectors. This "cross-silo" experience enables leaders to communicate effectively with diverse sets of stakeholders and systematically approach the challenges of developing and executing an impact investing strategy.

For women-led first time impact fund managers, I would recommend building a network of strong partners from 2X Challenge, fund administrator, legal counsel, placement agents amongst others who are aligned with the GP's mission, and will help establish their platform as an independent asset manager.

Sandrine Henton
Managing Director
EG Capital

Impact measurement and management

One hallmark of impact investing is the commitment to measure and manage impact, known as impact measurement and management (IMM). Successful IMM increases a fund manager's ability to demonstrate, articulate, and discern impact. When communicated effectively, this can mobilise more capital into the fund. Many impact fund managers release yearly impact reports that demonstrate their mission-related performance.

Good deployment of capital

Contrary to popular opinion, failing to raise capital is not the worst thing a fund manager can do. The worst thing is failing to deploy it effectively. LPs look for funds that demonstrate a clear pipeline of investments to continue throughout the lifecycle of the fund. A fund must demonstrate its strategy for sourcing potential investee companies and its approach to selecting deals for investment. A fund manager must present a universe of opportunities to LPs that closely aligns with its fund's investment thesis, impact strategy, and risk-return objectives.

Create efficiencies

A private equity impact investment fund requires a developed strategy for increasing the growth and efficiency of each of its portfolio companies to ultimately drive an increase in IRR and impact. The fund manager's job is to work with the entrepreneur to create an aligned vision for growing the company and increasing its profitability. Given the high-touch nature of the entrepreneur–fund manager relationship, fund managers should evaluate the number of portfolio companies they have and make sure they can dedicate adequate time and resources to each. Relationships with portfolio companies are most successful when they are hands-on and consistent throughout the investment lifecycle. Fund managers should have strong knowledge of the industry, sector, and associated technology that might improve the portfolio company.

Focus on one theme

Fund managers should direct their focus toward one theme versus many (e.g. an ocean fund, a climate fund, or a food fund). Avoid creating a fund that is more general, as it will be harder for investors to categorise the fund—and thus, less likely to invest. In a world that is becoming increasingly greenwashed, it's also crucial for fund managers to communicate why they are creating a fund. Why is the theme important to them? Without a strong 'why', a fund is in danger of being perceived as "chasing the market." Increasing numbers of investors are looking for value alignment with their GPs.

Rigorous screening

Funds should employ a rigorous impact screening mechanism at the pre-investment stage. There is nothing worse than an investment making it past the investment committee, only to be muted based on the impact.

Expect a learning curve

Funds often suffer from "first deal syndrome", where there can be a lot of pressure to deploy capital and get their fund started. (Note that this isn't specific to impact funds.) New impact funds should expect more of a J-curve when they look at their returns, as impact adds an additional layer to their investments. Impact funds may invest more heavily in improving certain areas, which can have a longer time horizon to profitability.

We are convinced that it is critical for emerging impact managers to secure not only GP alignment on the financial objective of the fund, but equally so on the impact objectives of the fund. At Urban Impact Ventures a malus on the carried interest applies when predefined impact objectives are not fully met; the proceeds are to the benefit of a foundation that provides grants to community initiatives alongside our urban investment theme. In this way, the LPs are equally exposed to financial and societal impact returns as long as the financial hurdle rate is met, whereas the GP is fully locked in on delivering both financial and impact objectives.

Hans van Houwelingen
Managing Partner
Urban Impact Ventures

Ready to launch your impact fund? Our team of experts can help.

IQ-EQ key contacts

Emma Crabtree
Group Chief Commercial Officer

E emma.crabtree@iqeq.com

Justin Partington
Group Head of Fund and Asset Managers

E justin.partington@iqeq.com

Edwin Chan
Chief Commercial Officer, UK & Ireland

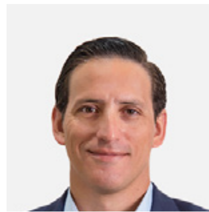
E edwin.chan@iqeq.com

Juan Dagniaux
Chief Commercial officer, The Netherlands

E juan.dagniaux@iqeq.com

Bram Eijsbouts
Chief Commercial Officer, Luxembourg

E bram.eijsbouts@iqeq.com



JP Gonzalez
Interim Chief Commercial Officer, The Americas

E jp@iqeq.com

Mirek Gruna
Chief Commercial Officer, Jersey

E mirek.gruna@iqeq.com

Sophie Hubert
Chief Commercial Officer, France

E sophie.hubert@iqeq.com

Rehma Imrith
Commercial Director, Mauritius

E rehma.imrith@iqeq.com

David Kim
Chief Commercial Officer, Asia

E david.kim@iqeq.com

Sarmad Naim
Senior Technical Regulator Manager, UK

E sarmad.naim@iqeq.com

Hugh Stacey
Executive Director Investor Solutions

E hugh.stacey@iqeq.com

Alex Stickler
Investor Solutions Commercial Manager, UK

E alex.stickler@iqeq.com

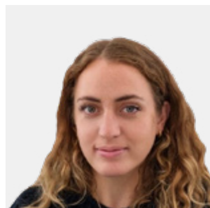
Jacques Vermeulen
Chief Commercial Officer Guernsey

E jacques.vermeulen@iqeq.com

Time Partners contacts

Crispin Payne
Chief Transactions
and Operating Officer

E crispin.payne@time-partners.com



Natalia Anninos
Associate

E natalia.anninos@time-partners.com

Hogan Lovells contacts

Nicholas Holman
Partner, London

E nicholas.holman@hoganlovells.com

Parik Dasgupta
Partner, New York

E parikshit.dasgupta@hoganlovells.com

Stephanie Keen
Partner, Singapore

E stephanie.keen@hoganlovells.com

Pierre Reuter
Partner, Luxembourg

E pierre.reuter@hoganlovells.com

James Wood
Partner, Sydney

E james.wood@hoganlovells.com

Hannah Kaye
Senior Associate, London

E hannah.kaye@hoganlovells.com

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