

Negative investor contribution

A summary of discussions with the IMP Practitioner Community

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About the Impact Management Project

The [Impact Management Project \(IMP\)](#) provides a forum for building global consensus on measuring, assessing and reporting impacts on people and the natural environment. It is relevant for enterprises and investors who want to manage environmental, social and governance (ESG) risks, as well as those who also want to contribute positively to global goals.

The IMP convenes a community of over 2,000 practitioners to share best practices, delve into technical issues and identify areas where further consensus is required in impact measurement and management.

It also facilitates standard-setting organisations that, through their specific and complementary expertise, are coordinating efforts to provide comprehensive standards and guidance related to impact measurement, assessment and reporting.

About the Predistribution Initiative

The [Predistribution Initiative \(PDI\)](#) is a multistakeholder project designed to co-create improved investment structures and practices that share more wealth and influence with workers and communities. Improved investment practices and structures are in service of an ultimate goal to address systemic and systematic risks, including but not limited to inequality, biodiversity, and climate change. PDI pursues this mission through workshops, research, publications, stakeholder engagement and field building.



Purpose

In 2019, the Impact Management Project (IMP) launched [Managing Impact](#), an online forum for the [IMP Practitioner Community](#) to discuss and debate technical topics related to impact measurement and management, and share best practices. Now, Managing Impact has over 420 members, and more than 130 thoughtful posts from individuals wanting to advance thinking around complex issues.

Each discussion runs on Managing Impact for four to six weeks before members of the IMP Practitioner Community convene via “huddles,” or webinars that gather participants to share their views in a live setting. These allow for a deeper dive into the more complex issues surrounding the topic before the insights from both the forum and huddles are synthesised into a discussion document.

The purpose of this paper – and the other discussion documents – is to shed light on the richness of the discussions for anyone who was unable to participate, whilst offering points for reflection to those who were. The goal is not to provide a definitive conclusion, but rather to take the pulse of IMP’s community of practitioners. Quotes from the huddles are anonymised given that these sessions were held under the Chatham House Rule.



Introduction to negative investor contribution

“Everyone knows that enterprises have major impacts on people and the planet, but what about investments?”

- Robert Eccles, Saïd Business School, in a [Managing Impact](#) discussion on investor contribution

“We asked participants to consider negative investor contribution, otherwise referred to as the ways in which investors – separately from the enterprises they finance – may engage in practices that result in social and/or environmental harm, and amplify systemic risks.”

From 2016-18, the Impact Management Project brought together a wide range of investors, businesses and academics to build consensus on how to measure, assess and report impacts on environmental and social issues.

Foundational to that consensus is the understanding that an investment’s impact is a function of:

1. The impact of the underlying asset(s) / enterprise(s) that the investment supports; and
2. The contribution that the investor makes to enable the enterprise(s) (or intermediary investment manager) to achieve that impact.

Moreover, practitioners reached consensus on [four strategies](#) by which investors can contribute to the impact of their portfolio companies/assets (see [Appendix 1](#)). The more recent [summary of consensus](#) delves deeper how these strategies may manifest differently in different asset classes.

These consensus-building efforts focused on potential positive impacts of investments on people and planet. Though examples of negative impacts of investments are often described in the media, the IMP consensus did not hitherto address the issue – an omission that we sought to remedy in partnership with the Predistribution Initiative.

In this discussion on [Managing Impact](#), we asked participants to consider *negative investor contribution*, otherwise referred to as the ways in which investors – separately from the enterprises they finance – may engage in practices that result in social and/or environmental harm, and amplify systemic risks.

As part of this effort, the Predistribution Initiative has created a [presentation](#) that introduces the issue of negative investor contribution in more detail and provides extensive links to articles, resources, and data on the topic. We encourage readers to review that presentation.

This paper does not recap that presentation, but rather synthesises perspectives expressed by the IMP’s community of practitioners. Unlike previous IMP discussion documents, this paper goes further by drafting examples of metrics with which investors can measure, manage, and disclose potential negative investor contribution. These are put forward in the spirit of a starting point that others expand and improve upon in the future.



Will voluntary disclosures help?

At present, metrics and disclosures of investor impact generally arise through coordinated, voluntary efforts of individual investors and enterprises, not from enforceable mandates of policymakers and regulators.

This approach may be more effective in some situations than in others. For instance, on the topic of positive investor contribution, investors might voluntarily pursue improved measurement and disclosure because they may benefit from greater reputational capital and “license to operate” by doing so. Of course, concerns remain that investors may exaggerate positive contributions, known colloquially as “impact-washing”.

In contrast, in the case of negative investor contribution, investors might hesitate to voluntarily pursue improved measurement and disclosure, because – bluntly put – transparency on negative investor contribution carries reputational risks. If so, efforts to address negative investor contribution through voluntary investor action might feel futile. However, while voluntary practices and disclosures may not be sufficient to ensure that negative investor contribution is measured, managed, and reported, there are several reasons why they may contribute to progress:

“While voluntary practices and disclosures may not be sufficient to ensure that negative investor contribution is measured, managed, and reported, there are several reasons why they may contribute to progress.”

- 1. Metrics that demonstrate negative investor contribution may bring more attention to issues that investors had rarely (if ever) thought of.** Some investors may not realise that they are having a negative contribution, or may not understand the harms experienced by people and the planet that result from it. Co-creating such metrics and disclosures, together with civil society, can help foster opportunities for investors to better understand their impacts, and for civil society to understand various aspects of finance.
- 2. Negative investor contribution (by other names) is already in the headlines** (see numerous examples linked in the presentation by Predistribution Initiative). More broadly, finance is viewed as among the least trustworthy professions by the public¹. As such, investors may see voluntary practices and disclosures related to negative investor contribution as an opportunity to improve public perceptions.
- 3. Investors may see voluntary efforts as an opportunity to get ahead of or contribute to regulation.** They may hope to forestall future regulation by “taking care of the problem themselves”, or influence future regulation by demonstrating practices and disclosures they regard as feasible.
- 4. For their part, regulators generally prefer to mandate practices and disclosures that have been tested and found to be feasible by at least some market participants.** Promulgation of voluntary standards may be a way to advance progress towards sensible regulation.

Asset owners and allocators have an important role to play in encouraging and supporting practices and disclosures related to negative investor contribution among the asset managers in whom they invest. Particularly in the case of institutional asset owners and allocators, there may also be opportunity to reflect on internal practices that may unintentionally have negative impacts. “Universal owners” – institutional investors so large that they have exposure to most or all companies, asset classes, and geographies in the market, with liabilities spanning decades in the future – have a particular incentive to support the development of such measurement and management tools, given that many of the negative impacts stemming from investor contributions can contribute to systematic or “undiversifiable” market risk in their portfolios².

1 Edelman (2021), [Global Report: Edelman Trust Barometer 2021](#)

2 Rothenberg, D.; Chappe, R.; Feldman, A. (2021), [ESG 2.0: Investor Risks Beyond the Enterprise Level](#)



Asset owners and allocators are not entirely free of conflict in this role, as they may financially benefit from the negative investor contributions of asset managers, at least in the short-term. But, institutional asset owners are typically long-term investors, with the bulk of their returns being influenced by systematic factors. They uniquely have the power and incentive to decide that they do not wish to benefit from certain types or levels of negative investor contribution, and can design mandates and allocate capital to asset managers accordingly³.

³ Lukomnik, J. and Hawley, J.P. (2021), [Moving Beyond Modern Portfolio Theory: Investing That Matters](#)



Accountability, governance, power and change

Participants observed that existing (albeit unstated) norms about negative investor contribution are embedded in the way that power and resources are distributed in societies. Given these power dynamics and entrenched interests, some participants expressed doubts about whether enhanced voluntary metrics and disclosures would make any difference to investors' behaviour:

"There are lots of ways of measuring negative social and environmental impact in the world. That's existed for some time now. The question is: why aren't they being used today? I'd be a bit worried about figuring out ways to measure negative investor contribution if they are not going to be used. It's not about a lack of methodology out there, it's about a lack of methodology being applied."

"I am concerned that the impact field has become too narrowly focused on metrics and indicators and standardisation, so much so that we're not actually having a strategic conversation. There have been too many arguments around what is happening. Until you have accountability about what matters, then you're not going to see the change that is required."

"In shaping and establishing any metrics to measure and manage negative investor contribution, it will be important to avoid ... power dynamics in their development. As such, it will be important to ensure that diverse stakeholders globally – with a wide range of specialties and lived experience – contribute to such efforts."

At the same time, others propose that these frameworks could be strengthened by including requirements for companies and investors to set targets relative to planetary boundaries and social norms^{4,5}. In addition, policymakers and regulators are beginning to leverage voluntary frameworks in their own development of mandatory standards. Such developments could enable existing and emerging disclosure efforts to have more impact. Either way, it will likely be difficult to establish any form of accountability without transparency regarding private sector activities that create negative impacts, and therefore improved disclosure.

Participants also observed an interaction between negative investor contribution and inequities in resource distribution across lines of race and gender. For example, in the United States, the United Kingdom and Europe, and between Global North and Global South geographies, the communities of asset managers and asset owners that benefit financially from negative investor contribution tend to be disproportionately white and male, while the communities that are harmed tend to be disproportionately non-male, black, indigenous, and people of colour.

"One area of potential negative contribution for community development financial institutions in the US is the gentrification of communities. There has been some interesting work done to try to understand in different ways how to measure gentrification, which is very difficult to do. But we've seen investors incorporate these assessments into their own practices to help avoid the risk of this outcome."

"There's a lack of diversity in the investment space, and it strikes me that it also contributes to the ways that investors are selecting assets."

In shaping and establishing any metrics to measure and manage negative investor contribution, it will be important to avoid these very power dynamics in their development. As such, priority should be given to ensuring that a diversity of stakeholders globally – with a wide range of specialties and lived experiences – contribute to such efforts.

4 r3.0, [Blueprint 6: Sustainable Finance](#)

5 World Benchmarking Alliance (2021), [Financial system transformation scoping report](#)



Towards a set of voluntary disclosures

With these considerations in mind, the IMP and the Predistribution Initiative have worked with leading investors and other market actors to collate a draft set of metrics and disclosures related to negative investor contribution. We also took the opportunity to solicit examples of metrics of positive investor contribution, with the aim of creating a balanced set of metrics by which investors might measure, manage, and report on both positive and negative investor contribution.

While the four investor contribution strategies (see [Appendix 1](#)) are generalisable across asset classes, the details manifest differently for private versus publicly listed securities. Therefore, draft voluntary disclosures are organised according to:

1. Negative (all asset classes);
2. Positive (private equity, venture capital and debt); and
3. Positive (public equity and debt).

These disclosures are of the actions employed by the investor, or the value of these actions to the investee. They do not represent the outcomes or impacts of those actions on the stakeholders affected by investee companies. The term “investor” primarily refers to asset managers, although we note that metrics for asset owners and allocators may also be valuable. The metrics also do not include guidance on targets or thresholds. We put these forward as a starting point for others to develop and refine further, and note that disclosures of impacts on affected stakeholders, as well as guidance on targets and thresholds and metrics for asset owners and allocators, will be important considerations in future refinements.



Draft investor contribution metrics

This initial list has been created for the purpose of serving as a basis for additions and improvements by others in the future. Some example metrics emerged from the discussion, while others were brainstormed by IMP and the Predistribution Initiative. These metrics have not gone through a process of public consultation, which is recommended to take place before any specific metrics are used by investors.

DRAFT SET 1 Negative (all asset classes)

Topic	Practices	Example metrics
Debt load	Increasing company indebtedness to a level that makes it vulnerable to default, layoffs, and bankruptcy, or that results in deterioration of quality jobs, goods, or services	<ul style="list-style-type: none"> Debt-to-equity ratio at transaction closing Pre vs. post-closing debt to EBITDA Debt to adjusted EBITDA vs. debt to reported EBITDA Dividend recapitalisations: Number, value, and percentage of closing debt Credit ratings pre- and post-transaction Carried interest charged only on unlevered returns Uses of funds from debt financing
Asset stripping	Selling companies' physical assets and then having companies lease them back, thus generating cash, but depleting the assets of the company	<ul style="list-style-type: none"> Ratio of value of sale-leaseback agreements to total value of company property, plant, and equipment (PPE) at time of transaction approval Ratio of total debt: PPE Percentage increase in expenditures as a result of a sale-leaseback agreement
Engineering of additional fees	Additional fees charged by the fund manager to the portfolio company for consulting, monitoring, or other services, or charged to investors	<ul style="list-style-type: none"> Disclosure of fees alongside portfolio company financial performance in quarterly and annual reports
Fund manager compensation and economic inequality	Disproportionate accrual of profits from portfolio companies to individuals within the fund manager relative to other actors in the "capital markets value chain" who take risk and create value (e.g. workers in portfolio companies and investors into funds)	<ul style="list-style-type: none"> Ratio of executive fund manager compensation to compensation of average or median worker in portfolio company (excluding corporate executives) at transaction closing, as well as at exit Number and structure of worker or community equity ownership programs (excluding corporate executives) created as part of transaction structures (can include phantom equity) Percentage of portfolio company workers with a living wage at closing versus at exit Percentage of staff laid off or terminated during the investment period (adjusted for acquisitions) Ratio of increase in financial value of employee ownership program to value of capital gains and fees to investors



Topic	Practices	Example metrics
Fund manager compensation and economic inequality (cont.)		<ul style="list-style-type: none"> • Placement of a portion of fund manager carried interest into a vehicle for portfolio company worker bonuses • Percentage of outstanding equity owned by non-director/executive officer employees at the company • Measurements of other profit-sharing mechanisms or placement of portfolio company workers or community stakeholders into distribution waterfalls • Adjustments to management fees for investors as the fund manager’s assets under management increase • For seasoned fund managers with track records, percentage of GP commitment
Tax responsibility	Minimisation of tax via exploitation of gaps and loopholes in corporate tax codes, including but not limited to expatriation of profits overseas via subsidiaries registered in tax havens	<ul style="list-style-type: none"> • Registration of fund entities and subsidiaries in tax-exempt locales • Effective tax rates of each company in portfolio • Taxes paid by each company in portfolio, by country • Commitments made by any portfolio company in order to benefit from tax incentives, and progress against commitments
Lobbying and political spend	Lobbying and political spend by the fund manager, key individuals within the fund manager, and controlled portfolio companies for activities that undermine the fund’s stated ESG and/or impact goals	<ul style="list-style-type: none"> • Total value of contributions made to each issue or candidate by each entity
Stakeholder engagement	Level of stakeholder input into investment and portfolio company strategy across stakeholder groups	<ul style="list-style-type: none"> • Existence and characteristics of grievance mechanisms at the fund manager and corporate levels • Freedom of association and collective bargaining at the fund manager and corporate levels • Existence and characteristics of worker and/or community representation in governance bodies of the fund manager or controlled portfolio companies • Evidence of stakeholder mapping by the fund manager and portfolio companies, including logs and records of engagement

Investment team incentives and performance evaluation, as well as asset allocation and portfolio construction strategies (particularly for asset owners and allocators), may be additional categories to explore, if not fully captured in the positive investor contribution strategies below.



DRAFT SET 2 Positive (private equity, venture capital and debt)

Topic	Practices	Example metrics
Signal that impact matters	Basing investment decisions in part on the current and expected future positive and negative social and/or environmental impacts of enterprises, and communicating to investees and the market at-large that you are doing so	<i>These descriptions of practices can themselves be used as process metrics (i.e., investors can simply state or demonstrate that they are implementing these practices)</i>
	Asking investees about social and/or environmental practices and performance	
	Publishing research and opinions on the positive and negative impacts of enterprise practices	
	Providing appropriate transparency to stakeholders about the negative and positive impacts of the enterprises in which you invest, and encouraging enterprises to provide similar transparency	
Engage actively	Join boards of directors and advocate for improving social and environmental practices	<ul style="list-style-type: none"> • Number of portfolio companies in which investor took a board seat and advocated for improving social and environmental practices (successfully / partially successfully / unsuccessfully)
	Provide consulting or technical assistance to help enterprises reduce negative social and environmental impacts and increase positive ones	<ul style="list-style-type: none"> • Provided consulting or technical assistance to help enterprises measure and reduce negative social and environmental impacts and increase positive ones (successfully / partially successfully / unsuccessfully)
	Use covenants to improve ESG / impact performance	<ul style="list-style-type: none"> • Include covenants in investment or loan documentation requiring borrowers to comply with established ESG standards and set time-bound action plans to close any identified gaps; management of a plan to pursue positive impacts may also be a requirement
	Introduce enterprise managers to experts relevant to their social or environmental impact	<ul style="list-style-type: none"> • Number of introductions to experts relevant to companies' social or environmental impact • Number of introductions to experts that led to changes in company decisions or practices
	Support enterprises post-investment in setting and achieving performance targets around impact	<ul style="list-style-type: none"> • Number of portfolio companies supported in setting and managing toward performance targets around impact
	Invest in strategies that facilitate worker or community ownership	<ul style="list-style-type: none"> • Provide equity to workers or communities who are stakeholders of an investment, or provide reasonably priced or concessionary debt to workers or community members to facilitate their ownership in an investment



Topic	Practices	Example metrics
Grow new or undersupplied capital markets	Provide an equity investment or loan with supportive terms, or in amounts that the enterprise likely would not have received but for the investor	<ul style="list-style-type: none"> Number / value of loans or investments that included supportive terms or amounts that the enterprise likely would not have received but for the investor <i>Can be broken down further into individual terms of transactions (e.g. pricing, fees, collateral, etc.)</i> Percentage of loans or investments in the portfolio (by number or value) that included supportive terms or amounts that the enterprise likely would not have received but for the investor <i>Can be broken down further into individual terms of transactions (e.g., pricing, fees, collateral, etc.)</i> Provide debt with an interest rate that declines when certain ESG milestones are reached
	Provide a guarantee or credit enhancement that others would not have, and that catalyses capital from third parties that the enterprise likely would not have obtained otherwise	<ul style="list-style-type: none"> Number / value of credit enhancements Estimated amount of capital catalysed by credit enhancements
	<ul style="list-style-type: none"> Lead a round of investment in an early-stage enterprise when other investors are not Serve as lead lender for a syndicated debt transaction when other lenders are not 	<ul style="list-style-type: none"> Number of investments (or percentage of investments in the portfolios) in which the investor led the round Number of loans (or percentage of loans in the portfolio) in which lender served as lead lender in a syndicate
	<ul style="list-style-type: none"> Accept a role or component of a larger financing package that no other investor accepts Take on complexity that other investors wouldn't, in order to structure a new type of financial product (e.g. a first-loss guarantee that enables the pilot of a new financial product, quasi-equity, permanent capital vehicle, and/or debt to fund worker or community ownership) 	<ul style="list-style-type: none"> [Qualitative / open-ended metric]: Description of what the investor did that no other investors would not do Number or percentage of investments in the portfolio for which this was the case
	Facilitate or arrange additional financing from third parties with supportive terms or in amounts that the enterprise likely otherwise would not have obtained	<ul style="list-style-type: none"> Estimated amount of capital facilitated or arranged (other than through credit enhancements, which has its own metric)
	Financing from third parties is contingent upon the investor's own investment	<ul style="list-style-type: none"> Estimated amount of third-party capital that was contingent on investor's investment
	Make a cornerstone investment in an emerging fund manager	<ul style="list-style-type: none"> Number / value of cornerstone investments in first-time fund managers Number / value of cornerstone investments in second funds of emerging fund managers



Topic	Practices	Example metrics
Provide flexibility on risk-adjusted return	<p>Investors should classify their investor contribution as <i>providing flexibility on risk-adjusted return</i> if they meet the requirements for <i>growing new or undersupplied capital markets</i>, and if in addition, they are accepting a lower financial return than they could obtain in investments with similar risk, liquidity, subordination, size and other financial characteristics.</p>	<ul style="list-style-type: none"> • [For an investment to count as “providing”, it also needs to include the disclosures demonstrating that the investment is growing new or undersupplied capital markets as per above.] • Number of investments or loans (or percentage of investments or loans in the portfolios) that included a concessionary element • Estimated financial value of concession embedded in the investment or loan, to the investor or lender • Estimated financial value of concession embedded in the investment or loan, to the investor or lender, as a percentage of transaction size • [Qualitative / open-ended metric]: Description of what element(s) of the transaction were concessionary (e.g., price, duration, liquidity, subordination, size, voting / control rights, conversion rights, etc.)



DRAFT SET 3 Positive (public equity and debt)

Topic	Practices	Example metrics
Engage actively	Vote on shareholder resolutions and company activities	<ul style="list-style-type: none"> • Number of company meetings voted (also as % of total company meetings) • Total proposals voted (also as % of total proposals available for vote) • Total proposals made or led (successfully / partially successfully / unsuccessfully) • Percent votes against management recommendation (can be broken out by topic, e.g. proposal for greater board diversity, reduced GHG emissions, etc) • Percent support for shareholder proposals (can be broken out by topic, e.g. proposal for greater board diversity, reduced GHG emissions, etc) • Percent support for management compensation plans
	Ally with social and/or environmental advocacy groups	<ul style="list-style-type: none"> • Number of advocacy groups the investor partnered with
	Directly communicate to investees your expectations about the negative impacts you expect them to avoid and the positive impacts you expect them to generate	<ul style="list-style-type: none"> • Number of engagement communications with company (can be broken down by meetings, letters, and shareholder proposals, by topic, and by successful / partially successful / unsuccessful)
Grow new or undersupplied capital markets	Provide in-depth support to efforts to improve third-party ESG and/or impact measurement and management standards that are relevant for issue area and asset class	<ul style="list-style-type: none"> • Third-party ESG and/or impact measurement standards supported or advised, and hours spent
	<p>Equities: The transaction caused or is expected to cause a material change in the share price. Situations in which a public equity transaction might directly cause a material change in the share price include, but are not limited to:</p> <ul style="list-style-type: none"> • New issuances of equity (whether IPO or secondary offering), if and only if the investor’s participation results in a change in offering price or terms • Secondary market transactions involving very large blocks of shares • Secondary market transactions by investors with particularly strong reputations 	<ul style="list-style-type: none"> • Number and value of secondary market transactions in which the transaction itself likely caused a material change in the share price; also as a % of total portfolio value • Number and value of investments in new issuances in which the investor’s participation likely resulted in a change in the offering price or terms to the company; also as a % of total portfolio value • Ratio of exposure to large versus smaller indices



Topic	Practices	Example metrics
Grow new or undersupplied capital markets (cont.)	<ul style="list-style-type: none"> Secondary market transactions by investors or funds that are known to be “activist” (e.g., Legal & General’s Future World GIRL Fund), or that are known to ally with issue-based activists, if that activism is expected to result in a change in company valuation Intentionally diversifying Exchange Traded Fund investments to gain exposure to smaller companies and reduce momentum-driving factors from market dynamics	See above
	Debt: Participation in a company’s debt offering caused or is expected to cause a material change in the amount, terms, or price of capital available to the company.	Number and value of investments in debt issuances in which the investor’s participation likely resulted in a change in the offering price or terms to the company; also as a % of total portfolio value

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Appendix 1: Positive investor contribution strategies

The impact of an investment = **the impact of the underlying assets x the investor's contribution**

Investors can use four strategies to contribute to the impact of its investments. These are often executed in combination:

- **Signal that impact matters:** investors can choose not to invest in, or to favour, certain investments such that, if all investors did the same, it would ultimately lead to a “pricing in” of social and environmental effects by the capital markets. Often referred to as values alignment, this strategy expresses the investors’ values and is an important baseline. But alone, it is not likely to advance progress on societal issues when compared to other forms of contribution.

The current consensus is that for investors to classify their strategy as *signalling that impact matters*, both positive and negative impact on people and/or planet, should significantly affect the investment decision. This means that impact considerations could lead to a different investment decision.

- **Engage actively:** investors can use expertise, networks and influence to improve the impact of businesses. Engagement can include a wide spectrum of approaches - dialogue with companies, creation of industry standards, taking board seats and providing hands-on management support (as often seen in private equity).

For investors to classify their strategy as *engage actively*, their engagement (above and beyond their financial investment) should have the potential to affect the impact of the enterprise on people and planet, by mitigating or reducing negative impact and/or increasing positive impact. Investors that are engaging actively typically have a systematic process for selecting enterprises which with to engage, a well thought-through engagement strategy and a rationale for why this strategy will create impact.

- **Grow new or undersupplied capital markets:** investors can anchor or participate in new or previously overlooked opportunities. This may involve more complex or less liquid investments, or investments in which some perceive risk to be disproportionate to return.

Investors should classify their strategy as *grow new or undersupplied capital markets*, when the investments directly cause or are expected to cause:

- A change in the amount, cost or terms of capital available to an enterprise that enables it to deliver impact that would likely not otherwise occur; or
- A change in the price of the enterprise’s securities, which in turn pressures the enterprise to increase its social and/or environmental impact and/or rewards it for doing so.

Investments are classified according to the IMP’s impact management norms as *growing new or undersupplied capital markets* if they meet the criteria above and are still targeting a competitive or market-beating risk-adjusted financial return. If investments meet the criteria above, but also deliberately accept a financial concession in order to do so, they are additionally classified as *providing flexibility on risk-adjusted financial return*.

- **Provide flexibility on risk-adjusted financial return:** investors can recognise that certain types of enterprises do require acceptance of lower risk-adjusted financial return to generate certain kinds of impact.

Provide flexible capital is the concessionary subset of *grow new or undersupplied capital markets*, while both are a subset of *signal that impact matters*. *Engage actively* can be deployed alongside any of the other three strategies.



Appendix 2: Comment from Malk Partners

In July 2020, Ryan Miller, Partner at Malk Partners, posted on Managing Impact about the various negative contributions that investors can make, and suggested some metrics that could be used to track and communicate them.

Since our experience is mostly with private equity firms, this post is written from the perspective of how these issues affect private equity firms, their portfolio companies and their limited partners. Some of these notes/resources may be relevant to other asset classes, but also might not be.

1. Debt loading

... I believe that placing a high debt burden on a portfolio company is a possibly significant negative investor contribution. As we've seen over the last decade, and increasingly over the past six months, companies that have a high debt load have less room for error when they experience a sudden drop in revenue or a spike in expenses. A high debt load can make the difference between a company sustaining market shocks and that same company going into default. If the company does go into default, we know that it is more likely to lay off employees or fail to pay suppliers and deliver to customers. In this way, the high debt load can result in a material negative impact on the company's stakeholders.

The debt load could be generated during the initial acquisition (i.e. pursuing a significant amount of leverage as part of the purchase), pursuing dividend recapitalisation (typically unsecured, high interest borrowing to provide a dividend to investors) and other strategies.

Possible steps/disclosures:

- Disclosing to limited partners/institutional investors the debt-to-equity ratio of the initial purchase and the current debt-to-TTM EBITDA ratio as part of a company's annual reporting requirements
- Investor commitment that it will not pursue dividend recaps as a post-acquisition strategy

Resources:

- [New York Times article on Cerberus/Remington that describes debt loading/dividend recaps](#)
- [Institutional Investor Article on Buyout Practices](#)

2. Asset stripping

While this may be less of a concern for impact investors, an historically common practice among private equity firms has been sale-leasebacks, in which the investor sells the assets of the company and the company then leases those assets. This can result in a quick burst of cash injected early in the ownership period, helping the investor realise higher returns, but ultimately leaves the company with reduced physical assets and correspondingly limited ability to generate cash when necessary.

Similar to debt loading, this could mean the difference between the company surviving a market shock and going into default. From my experience, sale-leasebacks most commonly involve the real estate of the company, though in principle, I suppose private equity firms could lease any capital equipment that has a significant value.



Possible steps/disclosures:

- Commitments from the investor(s) pre-acquisition that it will avoid sale-leasebacks unless necessary to sustain continued business operations
- Mandating disclosures from investors on the debt-to-Property, Plant and Equipment (PPE) ratio of the business
- Potentially endeavoring to secure a commitment from investors to refrain from increasing the debt-PPE ratio during the ownership period past a certain threshold, taking into account anticipated depreciation of fixed assets

Resources:

- [Middle Market Growth on the Sale Leaseback as a tool](#)
- [Allegation of the negative impact of a PE-sponsored sale leaseback](#)

3. Wealth inequality driven by carried interest

When an investment performs well, generating significant profits, free cash flows, or a high value at exit, that financial value is mostly concentrated among a few individuals at the private equity firm. The management team of the portfolio company may have equity in the company via a rollover or stock grant, but this is unlikely to be the case at the junior levels of the company. (Obviously, the extent of this depends somewhat on the sector; while stock options are more common tech, they are less common in areas like manufacturing.) The private equity firm's carried interest will be further aided by being taxed as capital gains, instead of ordinary income. In this manner, a successful investment may contribute to exacerbating wealth inequality between the private equity investment team and the employees of the company.

Possible steps/disclosures:

- Broad-based and meaningful employee ownership initiatives implemented as part of the transaction structure
- Commitment to placing a portion of carried interest into a vehicle for employee bonuses (this may be more complicated and significantly less tax efficient than providing ownership at the outset)
- Disclosing the percentage of outstanding equity owned by non-director/ executive officer employees at the company

Resources:

- [Background on carried interest](#)
- [Harvest Partners acquisition includes employee ownership](#)
- [KKR's employee ownership model](#)
- [An example of KKR's strategy](#)
- [Another example of KKR's strategy](#)

4. Tax avoidance reducing government revenues

(Full disclosure: I think this issue is potentially trickier to motivate than the others.)

There are widespread gaps in developed market tax codes that can be lawfully exploited to reduce a company's corporate tax rate, but I think the one that's worth exploring the most is the expatriation of profits overseas via subsidiaries registered in tax havens. When a company reorganises with a subsidiary in the Cayman Islands, Bermuda, Ireland, etc. and transfers a significant portion of earned income to that subsidiary (via transfer payments for IP, services, etc.) it reduces the tax revenue for the government where it may be head-quartered or conduct the majority of its business.

Similarly, when a fund develops a subsidiary in the Cayman Islands to allow certain investors to make fund commitments via that subsidiary, it reduces the taxable income base for the jurisdiction in which that investor is rightfully located. With so many necessary social and environmental services (e.g., housing subsidies,



provision of utilities, infrastructure spending, renewable energy R&D) dependent on government funding, a reduction in government's tax revenue because of tax avoidance negatively impacts the government's ability to fund the remediation of those issues.

I said this is trickier and I think it is because, right now, there are very few legal penalties for engaging in a tax avoidance schemes. Several EU governments have prohibited sending COVID-19-related fiscal relief to companies that have engaged in tax avoidance, but there is no guarantee that the governments will continue this policy position or act on the issue in the future. Similarly, there are sporadic episodes of shaming in the press of companies with low tax rates, but that hasn't proven to be enduring or target smaller/private equity-owned businesses. Without clear repercussions, investors have no reason not to pursue tax avoidance schemes and if they did decide to forego these schemes, they could be accused of breaching fiduciary duty to their investors or lose capital commitments.

Possible disclosures/steps:

- Investor commitments not to establish a tax-exempt fund subsidiary
- Investor commitments to paying taxes where value is created (not engaging tax avoidance)
- Disclosures by fund managers of effective tax rates for each company in their portfolios
- Producing a country-by-country report of net income, effective tax rate, and tax paid

Resources:

- [PRI working group paper on tax avoidance](#)
- [Academic review of PE impact on tax avoidance](#)
- [CEPR paper includes several PE issues \(debt, tax, carried interest\)](#)
- [BYU paper on tax avoidance in private funds](#)

IMPACT MANAGEMENT PROJECT



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Impact Management Project, September 2021