KEYNOTE INTERVIEW

Delivering on the promise

Paul Hastings' Vadim Avdeychik and Runjhun Kudaisya on the questions LPs should be asking to ensure quality impact outcomes

Q What changes have you seen in terms of demand for impact investment opportunities and what is driving that?

Runjhun Kudaisya: Over the last decade, impact investment has evolved from a nascent and disruptive investment concept, to something that is becoming more complex, multi-faceted and mainstream. There is definitely increased demand for impact products and services from individual and institutional investors, and asset managers are keen to provide those opportunities.

We have worked with a wealth management firm that raised an impact investing entity predominantly from high-net-worth individuals looking for more of a social and environmental focus, for example. We are also in the process of launching another vehicle backed by a government body looking for financial viability at the same time as targeting the big social and environmental goals.

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While demand is increasing, however, it is still a small proportion of the total private investment fund space. Of the numerous funds I worked on last year, just a handful focused on this strategy. So, the potential for future growth is also huge.

Q What questions should investors be asking as they seek to balance the appropriate financial risk and rewards with quality impact outcomes?

Vadim Avdeychik: I think it is important for investors to understand the metrics, and the frameworks, that a manager is using to make their investments. Are they simply using the SDGs as an overlay, and trying to fit their existing strategies into the UN SDG framework? Or are they actually making investments based on their ability to further enhance the SDGs? As investor interest in this space increases, there is a high probability that some managers are chasing AUM by greenwashing existing investments. It is important that LPs understand how their dollars will actually be used to create positive impact.

Investors should also explore whether a manager is using internal criteria to determine impact investment measurement or using standards provided by a third party, because that will reflect the nature of the reporting that those investors receive. They

need to be able to analyse and understand the benefit that has been generated so that they can report back to their own investment committees. At the end of the fund term, it should be possible to gauge how that fund has performed against the agreed objectives and reporting framework, but that is only possible if those objectives and reporting framework are clearly communicated at the outset.

RK: I think it is important to remember that investors have very different financial return expectations. Some are largely philanthropic and are investing for their strategic objectives, while others are absolutely looking to pursue competitive market-rate returns and, indeed, consider doing so to be a fiduciary duty. There are also investors who are looking to deploy capital sustainably while achieving profitable exits in social enterprises.

There is a lot of discussion about whether fiduciary responsibility only applies to financial outcomes or whether it extends to other outcomes also, but certainly many investors have a keen focus on the financial performance of impact funds.

In terms of questions we get asked in the marketing process – LPs ask about impact definitions; the proportion of impact investment companies in a fund; what the thematic verticals will be; what criteria will be used for selection; and what indicators will be used for monitoring. Investors will want to know whether that monitoring is passive or active; whether it is audited by a third party or comes straight from the underlying portfolio company; and what the level of reporting will be. I can tell you that with most of the funds we have worked with, there is no standard approach to the measurement and communication of impact, but it is certainly a very hot topic with LPs.

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>
> **RUNJHUN KUDAISYA**

Q What about the way in which managers resource impact? How significant is that for potential outcomes?

VA: Some of the larger managers tend to have a whole team of dedicated staff whose sole job it is to focus on impact investing. These teams spend time analysing the fundamentals of each specific investment using an impact lens. They make sure there is appropriate reporting and they also liaise with different third-party service providers to ensure that frameworks are being utilised properly when making investment decisions.

Smaller managers may not have quite as robust a team of individuals and may have fewer resources in place in order to provide dedicated staff. This is something investors need to bear in mind. If they are looking at a new entrant to the impact game, it is important that the manager is truly committed and has dedicated appropriate resources to ensure that impact is at the forefront of the investment strategy and not just being used as a marketing tool.

Q How are you seeing the impact investment ecosystem evolving? What range of opportunities are LPs faced with?

RK: The traditional concept of impact investing 11 years ago was very much aligned with creating purpose around companies. The parameters have since expanded and the breadth of opportunity has grown.

Historically, impact investment has focused primarily on low liquidity, innovative companies. But now it is also focused on more liquid and mature businesses that develop products or services that benefit society and the environment, ranging from energy efficiency, clean water and affordable housing to women-owned businesses and other SME development.

We have also noticed that investors are starting to think beyond equity investments. They are looking to embed impact into fixed income as well. We have come across structures like bond products to provide private capital to microfinance institutions and social enterprises in certain developing markets. We have also worked with an impact fund of funds. These are some examples of how the market is evolving and becoming more nuanced.

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>
> **VADIM AVDEYCHIK**

Q What does this increased complexity mean for measuring impact outcomes?

RK: There is a great deal of fragmentation, and that creates challenges around benchmarking and best practice. The market is lacking a common language and there is definitely a need for more clarity. But the industry is still in its early stages. All the funds we have worked on, for example, are still in the late offering or early investment period, with five to eight-year investment horizons. It won't be until those funds start to mature and deliver results that it will become clear which management systems are most effective. I think increased standardisation is essential, and it will come, but it will take some time.

VA: Investors themselves will ultimately coalesce around one framework or another. That is the way that it always happens. And it is what is needed for the industry to move forward.

Q Have the UN SDGs not provided some form of helpful framework?

VA: I think the SDGs have been really important for managers trying to identify and allocate resources consistent with those goals. However, investors, including private

Where does fiduciary responsibility lie?

Paul Hastings' Vadim Avdeychik on the regulatory environment governing impact investment

"The regulatory environment surrounding impact investment is different depending on which jurisdiction a private equity manager is looking to serve. In the US, there is very little specific regulation whatsoever. However, the Department of Labor, which oversees ERISA pension plan assets, published a Field Assistance Bulletin in 2018, which fundamentally says that fiduciary responsibility should focus on financial return and not solely on ESG, responsible or impact investing. Those things can be considered, but they should not be the primary goal.

"Then, just this year, we saw an executive order from the White House which directed the then Department of Labor chair to re-evaluate the current rules as they apply to ERISA fiduciaries with respect to voting of proxies. Reading the tea leaves, I think the rationale behind that executive order was to reiterate that fiduciaries should focus on maximising shareholder returns rather than any ESG policy goals.

"We are, however, seeing an uptick in various groups urging regulators to take action on ESG reporting. For example, in October 2018 we saw a petition to the SEC for a rulemaking on ESG disclosure. The signatories to this petition included certain notable securities law professors, asset managers and investors. Finally, more recently, the Business Roundtable chaired by Jamie Dimon of JPMorgan put out a statement noting that business leaders should commit to balancing the needs of shareholders with customers, employees, suppliers and local communities. These types of initiatives may drive greater focus in the US on impact investing, especially if we see an administration change.

"In contrast, what we have seen in Europe is almost the complete opposite. We are definitely seeing more proposals coming out of Europe that, in their current form, would appear to mandate greater reporting with respect to impact investments on both the investor and the management side."

equity investors have been crying out for more guidance on investments that satisfy SDG criteria. Just recently, the United Nations Development Programme proposed standards that investors and private equity managers can rely on when pursuing SDG investments. There are 31 standards that fall in three buckets. There are standards for strategic intent and goal setting, standards for impact measurement and standards for transparency and accountability. Those standards have been created at the request of the investment community, to help them make sure they are deploying capital in a way that specifically contributes to those SDGs. It comes back to Runjhun's point about the importance of a common language.

Q As we arguably approach another downturn, how is this unproven asset class likely to perform and what will that mean for its future?

VA: The industry hasn't experienced a downcycle. You are right. It is a relatively recent phenomenon, so it will be interesting to see how impact investments perform when the cycle turns. Our clients certainly seem to believe that impact investment should outperform because it offers a truly new way of looking at the world. We will have to wait and see, but if it plays out as managers believe it should, that will lead to even bigger inflows of capital as a result.

Remember, these are long-term investments. We will only truly know if the promised impact is delivered in 10 or 15 years. But given the scale of the global challenges these investments are seeking to address, I don't think the industry is going anywhere, anytime soon. I also believe that what we are now calling impact investment will simply become a natural part of all investment analysis. It will be what investors come to expect from any manager looking after their money. ■

Vadim Avdeychik is counsel in the Investment Management practice of Paul Hastings. He advises clients on the formation of impact funds and with respect to ESG policies and sustainable investing criteria. Previously, Avdeychik was counsel at PIMCO.

Runjhun Kudaisya is counsel in the Investment Management practice of Paul Hastings, advising on the formation, structuring and launch of private funds, including impact funds. She also counsels investment advisors in regulatory matters, including registration and compliance policies and procedures.