

## **Investor Contribution Definitions & Strategies**

Draft for public consultation, February 2023

[Impact Frontiers](#) and [The Predistribution Initiative \(PDI\)](#), with the support of [Omidyar Network](#), are jointly facilitating an industry consensus-building effort to develop resources that can support investors in measuring, managing, and reporting their positive and negative contributions to impact and systematic risk. Through this “Investor Contribution 2.0” (IC 2.0) project, we are inviting input and feedback via public consultation from February 21 through April 30, 2023, and will publish the final products as a public resource in mid-2023.

In this phase of the project, focused on private capital asset classes, we are inviting feedback on the proposed definitions described in this white paper, and on two related templates created to support investors:<sup>1</sup>

- [Direct Investment and Engagement Impact for Private Market Investors](#)
- [Investment Structures and Governance for Private Equity, Private Debt, and Venture Capital](#)

Responses are welcome via whichever medium listed below is most convenient for you. You may also choose to engage through all three options:

- **Zoom Huddles:** Join one of our open-invite interactive Zoom ‘huddles.’ Register via the links on the [project website](#)
- **Contribute** to our [online discussion forum](#)
- Email us responses to the definitions and/or templates directly at [info@investorcontribution.org](mailto:info@investorcontribution.org). We welcome your input via track changes, comments, or direct responses to any consultation questions within the documents themselves.

In addition to specific consultation questions throughout the documents, our overarching consultation questions are:

- Would you be willing to adopt and endorse the terms, definitions, and guidelines below as an emerging industry consensus? If not, what are the ‘must-haves’ that would need to change?
- Would you be willing to pilot the templates provided (as appropriate) and provide feedback to the project team, so that we can continue to improve them as a public good for investors? What would your feedback be?

We thank you in advance for your participation in this industry-building effort!

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<sup>1</sup> These drafts are a product of a period of approximately six months of desk work and engagements. Engagements included approximately 40 investors (including asset owners and allocators, asset managers, and one consultant), 20 field-building organizations and thought leaders in the impact investing and ESG communities, 10 academics, and two civil society organizations.

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## **Project Background and Scope**

IC 2.0 advances [work](#) that Impact Frontiers and PDI commenced in 2020 with the Impact Management Project to draft examples of metrics with which investors can measure, manage, and disclose investor contribution to impact and systematic risk. Numerous standards and sources of guidance exist to support companies’ management of their impacts, but little exists to support investors’ management and disclosure of their own contributions to impact and to systematic risk. This has left practitioners interested in measuring and managing their investor contribution the task of creating bespoke metrics and determining how best to integrate them into their investment processes and decision-making.

In 2022 and 2023, Impact Frontiers and PDI are facilitating a public consensus-building effort to update the definitions and strategies of investor contribution, and to co-create resources that private markets investors can use to manage and disclose their own investor contribution. We will publish the results as an open-access public good. We will also collaborate with standard-setters and regulators to integrate these resources into their work at the conclusion of the project.

To organize our work, we began with the investor contribution strategies articulated by the Impact Management Project between 2016 – 2018. We proposed targeted changes in nomenclature to add additional granularity and understanding of what is, and what is not, considered investor contribution. We expanded the framework to include negative impacts and systematic risk. Finally, we created templates and draft disclosures that investors can use to manage and disclose their own investor contribution. We believe this shift will enable increased rigor of practice and clarity in communications about impact within investment firms and with external stakeholders.

For more about the goals, scope, and methodology of the project, please see the Appendices.



## Summary of Emerging Consensus on Investor Contribution

In discussions with investors and our review of existing industry resources, we are hearing an emerging consensus that there are (at least) four channels by which investors seek to influence outcomes for end-stakeholders and the natural environment that likely would not have occurred in the investor’s absence (hereafter simply ‘outcomes’):

- Capital allocation / investment and divestment
- Non-financial engagement
- Choice of investment structures
- Internal firm management

We are hearing an emerging acceptance that investors vary in the importance they place on causing changes in outcomes. Finally, we are hearing an emerging recognition that within each of these four categories above, there is variation in the degree to which investor actions cause or are expected to cause changes in outcomes:

- Some investor actions do (or very likely do) cause changes in outcomes. We group these together under the heading of **“Investor contribution.”**
- Some investor actions do not on their own cause changes in outcomes – but if all investors took similar actions, would likely lead to changes in outcomes. We group these together under the heading of **“Signaling preferences for outcomes.”**
- Some investor actions do not cause changes in outcomes. These are not relevant to investor contribution so not discussed further.

Putting it together, investors have four channels for influencing outcomes, and within each channel, a range of possible actions with varying likelihood of causing changes in outcomes (examples listed on pg. 5):

	Signaling preferences for outcomes	Investor contribution
Capital allocation		
Non-financial engagement		
Investment structures		
Internal firm management		

**Key Point:** The same or very similar investor actions may constitute ‘signaling preferences’ in one context or time, and ‘investor contribution’ in another. For instance, providing a small loan to a large clean energy business with a strong credit rating and many plausible alternative lenders would likely be a form of capital allocation that ‘signals preferences,’ while providing the same or similar loan to a small first-time clean energy borrower with no other plausible lenders would likely be a form of capital allocation with ‘investor contribution.’ Similarly, during portions of the market cycle in which capital is relatively plentiful and funds are competing to participate in fundraises of the most attractive companies, it may be more difficult to create investor contribution than during downturns in which capital is scarce.

## Working Definitions

**Investor Contribution:** investor actions that cause or are expected to cause a change in outcomes for end-stakeholders, the natural environment, and/or systematic risk, that would not have likely occurred in the absence of those actions.

Given that investors will often not be able to definitively prove what would have happened in their absence or the absence of a certain activity, we propose that an action qualifies as investor contribution if the investor can provide a plausible narrative connecting their specific action(s) to specific changes in outcomes that would not have likely occurred otherwise.

Note on 'plausible narrative': plausibility to be determined by the relevant decision-maker, e.g. asset owners/allocators, and ideally informed by the views of the affected stakeholder(s).

**Signal preferences for outcomes:** when an investor proactively and systematically considers one's own and investees' measurable positive and negative impacts on stakeholder outcomes and systematic risk as a part of their decision-making, and communicates this consideration internally, to investees, and the market at large. For those familiar with the IMP consensus (see Appendix 3), this strategy includes:

- **Signaling investment**, formerly termed "Signal that impact matters" in the IMP consensus; and
- **Signaling engagement**, a new category not included in the IMP consensus. Stewardship professionals increasingly observe the distinction between 'signaling engagement' and 'direct engagement impact,' hence this addition.

**Systematic risk:** In this paper, we refer to non-diversifiable pervasive risks such as climate change, biodiversity loss, and inequality as 'systematic risks.' In colloquial usage, these risks are often termed 'systemic risks.' However, in the financial services sector, the technical term 'systemic risk' typically refers to the risk that the failure of one institution or industry could cause a cascading series of failures, resulting in a market-wide crash and/or economic downturn. The technical term 'systematic risk' refers to "the risk inherent to the entire market, attributable to a mix of factors including economic, socio-political, and market-related events (Investopedia)." As such, for the remainder of this paper, we refer to risks such as climate change, biodiversity loss, and inequality as "systematic risks" rather than "systemic risks."

Investors can pursue either or both of these strategies through their capital allocation, choice of investment structures, non-financial engagement, and/or internal firm management. Investors classify these actions as investor contribution if they can identify a plausible narrative connecting specific action(s) to specific changes in outcomes that would not have likely occurred otherwise, and as signal preferences if they cannot, but expect that outcomes would improve if all investors took similar actions.

The following table provides illustrative examples of each type of action.

## Illustrative Examples of “Signaling” and “Investor Contribution” Actions

	Signal preferences for outcomes	Investor contribution
<b>Capital allocation</b>	<p>Investor A invests in Enterprise X, whose product/service improves outcomes for end-stakeholders.</p> <p>Other investors would have likely invested the same amount of capital, at the same price and with the same terms, if Investor A had not invested in Enterprise X.</p> <p>Investor A believes that if sufficient numbers of investors allocated capital towards enterprises whose products / services improve outcomes for end-stakeholders, and away from those that don't, then more enterprises would be likely to <b>improve outcomes</b> for their end-stakeholders.</p>	<p>Investor A invests in Enterprise X, whose product/service improves outcomes for end-stakeholders.</p> <p>Investor A provides cheaper debt to Enterprise X than they likely would have otherwise obtained.</p> <p>This enables Enterprise X to raise more capital than they otherwise would have, and expand its operations to reach more end-stakeholders than they otherwise would have.</p> <p>As a result, a greater number of end-stakeholders experience <b>improved outcomes</b> than would have likely been the case, had Investor A not invested in Enterprise X.</p>
<b>Investment structures</b>	<p><i>Not Applicable. Investors influence investment structures either through direct control (see the description to the right), or through capital allocation decisions and non-financial engagement with investees or potential investees.</i></p> <p><u>Consultation question:</u> can you think of examples of investment structures that would qualify as 'Signal preferences'?</p>	<p>Investor A takes a controlling equity stake in Enterprise X and finances the acquisition, as well as dividend payments, with high levels of debt that sit on Enterprise X's balance sheet.</p> <p>To manage the debt burden, Enterprise X must cut costs relating to quality jobs.</p> <p>As a result, employees experience <b>worse outcomes</b> than would have likely been the case, had Investor A not invested in Enterprise X.</p>
<b>Non-financial engagement</b>	<p>Investor A invests in Enterprise X, whose product/service improves outcomes for end-stakeholders.</p> <p>Investor A encourages Enterprise X to consider ways to mitigate GHG emissions in their supply chain, but does not require it to do so.</p>	<p>Investor A invests in Enterprise X, whose product/service improves outcomes for end-stakeholders.</p> <p>Investor A leverages their ownership stake and board seat to implement a GHG emissions mitigation strategy for Enterprise X's supply chain.</p>

	<p>In Investor A's absence, Enterprise X's other investors (or likely alternative investors) also would have advocated that Enterprise X consider ways to mitigate GHG emissions in their supply chain.</p> <p>Investor A believes that, if sufficient numbers of investors encouraged their investees to mitigate GHG emissions in their supply chain, then more enterprises would be likely to mitigate GHG emissions in their supply chains, and thereby <b>improve outcomes</b> related to climate change.</p>	<p>In Investor A's absence, Enterprise X's alternative investors would have been unlikely to pursue comparable GHG emissions reductions in Enterprise X's supply chain.</p> <p>As a result, fewer GHGs are emitted from Enterprise X's supply chain than would have likely been the case if Investor A had not invested in Enterprise X, thereby <b>improving outcomes</b> related to climate change.</p>
<p><b>Internal firm management</b></p>	<p>Investor A holds internal workshops on the importance of diversity, equity, and inclusion in fund leadership, but does not institute or enforce DEI-related employment practices.</p> <p>Investor A believes that, if sufficient numbers of investors held internal workshops on the importance of diversity, equity, and inclusion in fund leadership, then more investors would be likely to assemble diverse leadership teams, thereby <b>improving outcomes</b> related to DEI.</p>	<p>Investor A institutes formal DEI-related employment practices that result in an increase in the diversity of its leadership team, thereby <b>improving outcomes</b> related to DEI.</p>

**Signal Preferences: Important in itself, and a necessary baseline for investor contribution**

The signal preferences strategy is important and valuable for all investors. If all investors pursued this strategy, and if they agreed sufficiently on which social and environmental outcomes were desired, it would ultimately lead to a 'pricing in' of social and environmental effects by capital markets that would improve outcomes and reduce systematic risk. However, individual actions in this strategy do not on their own cause specific changes in outcomes.

This strategy is also a **necessary baseline** for positive investor contribution: without it, investors are liable to contributing to negative impacts and systematic risks in some parts of their portfolio, even as they seek to avoid or mitigate those outcomes in other parts.

## **Investor Contribution: Changing real-world outcomes**

As described above, investors can pursue investor contribution through:

1. Direct Investment Impact: allocation of capital to enterprises and/or intermediary investment manager(s) (investees)<sup>2</sup>
2. Direct Engagement Impact: Non-financial engagement with investees
3. Choice of investment structures, and/or
4. Internal firm management.

The first two focus on the financial and non-financial resources committed to investees, as well as requirements that the investor imposes, that:

- the investee would not otherwise have access to or been required to pursue; and
- enable the investee to cause changes in outcomes for people and the planet and/or mitigate systematic risks.

These two are typically implemented by investors seeking positive impact, though it is important for investors also to consider negative and unintended impacts of their actions.

The third is intended to capture the ways in which investment structures and incentives distribute risks and returns across asset owners and allocators, asset managers, operating enterprises (or municipalities and sovereigns), and all of these entities' stakeholders. For instance, investment structures and incentives may cause economic benefits to be concentrated among large private capital asset managers while risks are distributed up to asset owners and down to enterprises and stakeholders – or the opposite, depending on choice of investment structures and incentives.

Finally, investor contribution also includes investors' own direct effects on stakeholders and on systematic risks through their internal firm management, for instance through employment, compensation, and emissions associated with the investment firm. Investors also contribute to social and environmental outcomes through their actions in areas such as responsible political engagement and tax fairness.

The first two forms of investor contribution are explored in more detail below.

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<sup>2</sup> Investees and intermediary investment managers are collectively referred to as “investees” throughout the remainder of this document.

**Direct Investment Impact:** Formerly “Grow new or undersupplied capital markets” in the IMP consensus, these are investments that directly cause or are expected to cause:

- a change in the amount, cost, or terms of capital available to an investee that enables it to deliver a positive impact that would likely not otherwise occur, or prevent a negative impact that would likely otherwise occur; or
- a change in the price of the asset’s securities, which in turn pressures the enterprise to improve its positive impact, reduce its negative impact, and/or incentivizes it for doing so.

The above conditions do not necessarily require flexibility on risk-adjusted financial return, though that may sometimes be the case. (See “Flexibility on Risk-Adjusted Financial Return” below.)

This strategy may include:

- Individual Direct Investment Impact: Investments made by individual firms;
- Collaborative Direct Investment Impact: financial participation in a syndicated or blended finance transaction that would not likely occur but for the investor’s participation, and that meets the criteria above; and
- Catalytic Direct Investment Impact: capital provided by third parties that meets the above criteria and is caused by the investor’s own investment and/or engagement.

Investors increasingly distinguish between three tiers of direct investment impact that are qualitatively different:

- Tier 1: Capital that an investee likely would not otherwise have obtained. This could be provided by the investor themselves, or by third parties contingent on the investor’s own commitment. The investor contribution in this case is the amount of capital in excess of what the investee likely otherwise would have obtained.
- Tier 2: Capital that the investee likely would have obtained otherwise, but the investor is providing terms and conditions that are more beneficial than the investee likely would have obtained. The investor contribution in this case is not the amount of capital, but rather the difference between the terms and conditions offered by the investor and those that the investee likely otherwise would have obtained.
- Tier 3: The characteristics, identity, or reputation of the investor is more beneficial than that of the investee’s other investors, but the capital and associated terms and conditions are the same or similar to what the investee would otherwise have obtained. This form of investor contribution is commonly cited by development finance institutions.<sup>3</sup>

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<sup>3</sup> For instance, the [Multilateral Development Banks’ Harmonized Framework for Additionality in Private Sector Operations](#) includes the following under the heading of ‘non-financial additionality’: “MDBs provide comfort to clients and investors by mitigating non-financial risks, such as country, regulatory, project, economic cycle, or political risks. Such comfort is often due to MDBs’ reputation in the market, role as honest brokers, trusted and long-term client partnerships, signaling function for sound projects, convening power, close relationships with governments, and rigorous due diligence processes.”

**Direct Engagement Impact:** Non-financial activities that cause or are expected to cause a change in investee actions, that in turn causes a change in outcomes for stakeholders and/or the natural environment.

This strategy includes:

- Individual Direct Engagement Impact: Direct engagement by individual investment organizations that in turn causes a change in outcomes for stakeholders, the natural environment, and/or systematic risk (assumed unless otherwise noted); and
- Collaborative Direct Engagement Impact: Participation in coordinated multi-investor efforts that engage (and/or vote, as applicable) with investees to cause a change in the investee's actions, that in turn causes a change in outcomes for stakeholders, the natural environment and/or systematic risk.

## Flexibility on Risk-Adjusted Financial Return

In the consensus facilitated by the IMP, ‘flexibility on risk-adjusted financial return’ was an investor contribution strategy in its own right. “Flexible” investments were the subset of “Grow New and/or Undersupplied Capital Markets” investments in which the investor accepts a lower financial return than the investor could obtain in investments with similar risk, liquidity, subordination, size, and other financial characteristics (or, equivalently, accepting the same financial return but with more risk, less liquidity, etc.) in order to generate certain kinds of impact that otherwise would not be possible.

We propose to remove “Flexibility on risk-adjusted financial return” as an investor contribution strategy for several reasons. Firstly, it is not an investor contribution strategy in itself, but rather a tactic by which to pursue direct investment impact by offering capital with amounts, terms, or conditions better than the investee otherwise likely would have obtained. Secondly, considering “Flexibility” to be an investor contribution strategy in and of itself may inadvertently encourage investors to make one or both of the following assumptions:

- If the investor accepts greater risk or less financial return than they could otherwise obtain, they will **always** achieve direct investment impact; and
- Accepting greater risk or less financial return than they could otherwise obtain is **always** necessary to achieve direct investment impact.

Instead, investors increasingly treat assessments of risk-adjusted financial return and of investor contribution as separate exercises that rely on distinct comparisons.

Assessment of financial concession entails a comparison between:

1. The financial return of an investment to the investor, as opposed to:
2. The financial return that the investor could make in the best possible alternative investment whose other financial characteristics were as similar as possible (e.g., risk, liquidity, subordination, voting rights, etc.).

By contrast, assessment of investor contribution entails a comparison between:

1. The outcomes experienced by stakeholders and the natural environment as a result of an investor’s investment in and/or engagement with a company; and
2. The outcomes that likely would have been experienced by stakeholders and the natural environment in the absence of the investor’s investment and/or engagement.

Investors with the ability and willingness to accept reduced financial return (or greater risk) in exchange for impact that would likely not otherwise occur often undertake both assessments independently and then compare the results. In other words, they assess the financial concession versus their best available alternative; the extent to which the investment will likely create impact that would not otherwise occur; and then consider whether the impact is worth the financial concession.

Investors do not always conduct separate analyses of financial concession versus investor contribution, rather assuming that each implies the other. However, this increases the risk that the investor will accept a financial concession in exchange for impact that would likely have occurred otherwise, and/or miss opportunities for impact that do not require a financial concession.

## Guidelines for Investor Contribution

The following guidelines are closely based on the [Multilateral Development Banks' Harmonized Framework for Additionality in Private Sector Operations](#), with changes made only to increase applicability beyond MDBs, and replacing the word 'additionality' with 'investor contribution'.<sup>4</sup>

1. Investor contribution is generally assessed investment by investment; however, direct engagement impact may be assessed at the investee level across multiple engagement interactions over time.
2. Investor contribution may be assessed across a set of investments as a group when they have very similar or identical features and contexts.
3. Investor contribution assessments are based on available evidence and knowledge of the market context of the investment at the time of approval. Examples of potential sources of evidence are provided in section 5 of the [MDB Harmonized Framework](#) on pages 11-12.
4. An assessment of investor contribution is contextualized and may differ by country, sector, market, and/or investee type. Within the same country, levels of risk may vary across sector, market, and/or investee type.
5. Investment and engagement teams are responsible for identifying and demonstrating investor contribution, which may be supported or verified through an internal validation process.
6. Asset managers are accountable to asset owners and allocators for demonstrating investor contribution consistent with agreed-upon goals.

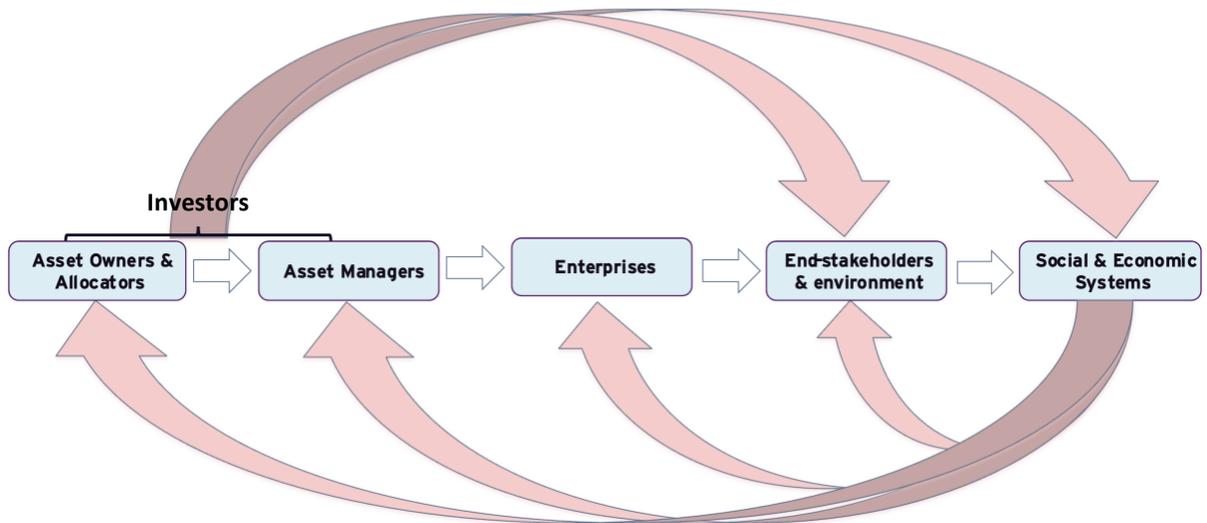
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<sup>4</sup> The seventh guideline from the MDB Harmonized Framework is “As part of their respective mandates, independent evaluation offices provide checks and balances by considering the investor contribution of MDB operations as part of their ex-post evaluation activities.” We propose to exclude this given that other investors do not have independent evaluation offices. As the practice of impact performance report assurance evolves, it is likely that investor contribution performance may be assured alongside other elements of impact performance.

## Appendices

### Appendix 1. Scope and Methodology

The IC2.0 project seeks to address not only the effects that investors have on investees (and thereby on end-stakeholders and the natural environment), but also investors' effects directly on end-stakeholders, the natural environment, and social and economic systems.



We first present the methodology for investor contribution to systematic risk, as it is relevant to all investors. We then present the scope and methodology for investor contribution to positive impact separately, as it is primarily of interest to impact investors.

## Appendix 2. Investment Structures and Governance for Private Equity, Private Debt, and Venture Capital

PDI and IF undertook a limited literature review to explore how investor actions – particularly those related to investment structures and governance – potentially contribute to systematic risks as well as direct negative impacts on end-stakeholders.

We are currently undertaking an assessment of how institutional investors who are less active in the impact investing community, but who are more active in the environmental, social, and governance (ESG) community, assess investor contribution. ESG considerations primarily focus on risks related to portfolio company operations, leveraging standards such as the Sustainability Accounting Standards Board (SASB) and, depending on the interpretation of ESG, the Global Reporting Initiative (GRI), and other comparable frameworks.

The IC2.0 project addresses issues often excluded from ESG data and analysis in two regards. First, ESG data and analyses typically do not account for positive or negative externalities. Second, ESG data and analyses primarily focus on portfolio company operations, rather than investor contribution. This may be partially due to the fact that the primary outcomes which are assessed are those which are financially material, and financial materiality is assessed at the portfolio company level, rather than the fund or investment vehicle-level.

Several exceptions exist. For instance, when it comes to governance and diversity, equity, and inclusion (DEI), institutional asset owners and allocators in private asset classes do have several frameworks for assessing fund managers, such as the Institutional Limited Partners Association (ILPA) principles and guidance in the private equity asset class. In this project, we have therefore referenced these frameworks where applicable, as opposed to proposing new metrics or disclosures, so as not duplicate work.

In both public and private equity-oriented asset classes, due diligence tools are emerging to hold asset managers accountable on how they manage ESG risks with their portfolio companies, as well. Examples of organizations producing such guidance include the Committee on Workers Capital (with a focus on workers), the Task Force on Climate-related Financial Disclosures (TCFD), the Task Force on Nature-related Financial Disclosures (TNFD), the emerging Task Force on Inequality-related Financial Disclosures (TIFD), Ceres Investor Network on Climate Risk (INCR), The Investment Integration Project (TIIP) and the Net Zero Asset Owners Alliance.

Nonetheless, unlike in impact investing, where the Impact Management Project explicitly developed tools to assess whether investors create positive impacts, investment structure and certain aspects of governance are not typically or comprehensively assessed in ESG data and analysis.<sup>5</sup> This matters because investors can contribute to negative impacts and systematic risks that affect stakeholders and markets through the way they structure investments and the incentive structures informing how they

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<sup>5</sup> This project uses the term “investment structure” to refer to an investor’s or its controlled entities’ capital structure, tax structure, distribution waterfall, and/or fee and carried interest structures.

allocate assets. The below image, the [Research and Resources database](#), a forthcoming case study, and the template "[Investment Structures and Governance for Private Equity, Private Debt, and Venture Capital](#)" include more information on these dynamics.<sup>6</sup>

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<sup>6</sup> Although issues at the asset owner and allocator level are included in the below diagram and identified in the literature, they are not included in the scope of this phase of the project. However, asset owners and allocators set incentives for asset managers and may have difficulty leveraging the disclosures proposed in this project without addressing the issues identified in the two right-hand columns below. As such, PDI is engaging in separate projects to support asset owners and allocators on these topics. A future phase of Investor Contribution 2.0 may explore measurement and management tools for asset owners and allocators to improve their internal practices regarding positive impact and reduced systematic risk as well.

# EXAMPLES OF ESG ISSUES IN INVESTMENT PRACTICES + STRUCTURES

Issues at both asset manager + asset owner and allocator levels

FUND MANAGER COMPENSATION	FINANCIAL ENGINEERING	TAX AVOIDANCE & POLITICAL ACTIVITY	INVESTMENT GOVERNANCE	VALUATION METHODOLOGIES & FINANCIAL ANALYSIS
<ul style="list-style-type: none"> <li>High CEO and fund manager compensation, which can exacerbate economic inequality (e.g., 2-and-20 model in alternatives or fees of banks and placement agents)</li> <li>Economic inequality can result in secular stagnation, asset price inflation, imbalanced power dynamics in societal decision making, polarization, and social instability that leads to market instability (as well as more recently, an ESG backlash)</li> </ul>	<ul style="list-style-type: none"> <li>Leverage ratios, which can overburden portfolio companies with debt to the point where they can't offer quality jobs and quality and affordable goods and services, and which can lead to debt crises</li> <li>Asset stripping, whereby portfolio companies are pushed to sell assets and sometimes lease them back</li> <li>Dividend recaps, which can extract value from companies to pay investors</li> <li>Blitzscaling investments in the Venture Capital asset class to the point where portfolio companies have to cut corners on responsible practices to maintain rapid growth, or engage in anti-competitive practices</li> </ul>	<ul style="list-style-type: none"> <li>Domiciling funds in tax havens</li> <li>Fee and carry waivers</li> <li>Lobbying and political spend (e.g., to protect surprise medical billing at portfolio companies, maintain carried interest loophole, erode labor rights, secure bailout funding or influence, etc.)</li> </ul>	<ul style="list-style-type: none"> <li>Misalignment of responsible investment team, investment professional team, and portfolio company executive goals</li> <li>Investors may have long-term time horizons, but more frequent performance reviews and short-term metrics</li> <li>Interpretations of fiduciary duty and materiality don't integrate systemic and systematic risk</li> <li>Career risk from new choices</li> <li>Bureaucracy of large institutions and challenge of deconsolidating capital flows, which can squeeze out diverse and emerging managers and SMEs</li> </ul>	<ul style="list-style-type: none"> <li>Issues relating to systemic, systematic risk and intergenerational fiduciary duty inherent in:               <ul style="list-style-type: none"> <li>Accounting (e.g., cost of capital, workers as expense)</li> <li>Financial analysis (e.g., IRR vs. MOIC or TVPI, MPT),</li> <li>Benchmarking practices that do not account for externalities</li> <li>Lack of tools and methods to measure and account for systemic and systematic risk</li> </ul> </li> <li>High-risk and consolidated capital flows in asset allocation (procyclical asset allocation which can lead to asset bubbles and credit crises)</li> </ul>

Beyond impact investing and ESG, this project is strongly aligned with emerging concepts in capital markets including Universal Ownership, System-level Investing, and Systemic Stewardship.<sup>7</sup> Unlike commonly practiced forms of ESG integration, these approaches seek to measure and manage externalities to avoid systematic risks. Assuming that systematic risks and value can be integrated into financial analysis and thus factored into investment decision-making, broadly diversified investors who have an intergenerational fiduciary duty to seek risk-adjusted returns should seek to reduce negative externalities or impacts on human and natural systems. They may even seek to optimize the investment portfolio to enhance positive externalities or impacts on human and natural systems.

It is commonly accepted in the impact, ESG, and System-level investing communities that portfolio companies of investors can influence climate, nature, social outcomes, and financial stability. IC 2.0's literature review thus far has documented that not only portfolio companies, but also asset managers and asset owners and allocators engage in activities that can cause negative impacts and risks as well as positive impacts. Examples of supporting literature and the risks and impacts that they document are included in the accompanying [Research and Resources](#) document.

The IC 2.0 project contributes to supporting investors in measuring and managing investor contribution to systematic risks – focusing on the risks created by investment structures and certain investment governance practices – by working with diverse stakeholders to co-create relevant disclosures.

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<sup>7</sup> First coined by Robert Monks and Nell Minow, "Universal Ownership" suggests that certain institutional investors have reached such size and scale that they are exposed to every industry, asset class, and geography in their portfolios, thereby "owning the market," which is a reflection of the economy. As Jon Lukomnik and Jim Hawley note in their book, *Moving Beyond Modern Portfolio Theory: Investing That Matters*, the health of the overall market and economy affect an investor's returns more than security selection. If an individual investment results in negative externalities to the economy, and therefore the market, even if that investment produces a near-term return, it may not be in the interest of the investor's portfolios, particularly long-term investors with intergenerational fiduciary duties like pension funds, insurance companies, and sovereign wealth funds. According to The Investment Integration Project (TIIP) who coined the term, "System-level Investing," the concept may be defined as the intentional consideration by investors of the bigger-picture environmental, social, or financial system context of their security selection and portfolio construction decisions. The financial community relies on these systems for profitable investment opportunities and to maintain stable business operations and functioning financial markets.

Systematic Stewardship is an approach to investing or shareholder engagement that accounts for the negative systematic impacts.



### Appendix 3. Direct Investment and Engagement Impact for Private Market Investors

To organize our work, we began with the investor contribution strategies articulated by the Impact Management Project between 2016 – 2018, and then proposed targeted changes in nomenclature to add additional granularity and understanding of what is, and what is not, considered investor contribution. We believe this shift will enable increased rigor and transparency when planning for, measuring, and managing impact investment strategies moving forward.

The four investor contribution strategies outlined by IMP are as follows:

- **Signal that impact matters:** Investors employ this strategy when they proactively and systematically consider measurable positive and negative impacts of assets as part of their investment decision-making process, and communicate this consideration to investees and the market at large. These considerations should affect the investment decision, meaning that impact considerations could lead to a different investment decision.

If all investors implemented 'signaling' strategies, 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 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.

- **Engage actively:** Investors may go beyond signaling that impact matters to proactively support or advocate for assets to reduce negative and increase positive impacts. This might involve, for example, filing a shareholder resolution, joining the board, providing consulting or mentoring, or participating in industry-level or regulatory efforts to promote considerations of sustainability in financial markets.

Investors that are engaging actively typically have a systematic process for selecting assets with which to engage, a well thought-through engagement strategy, and a rationale for why the chosen strategy is expected to affect the impact of the asset.

- **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. Investments directly cause or are expected to cause:
  - a change in the amount, cost, or terms of capital available to an asset that enables it to deliver impact that would likely not otherwise occur; or
  - a change in the price of the asset's securities, which in turn pressures the enterprise to improve its impact and/or rewards it for doing so.
- **Provide flexibility on risk-adjusted return:** A sub-set of investors who are growing new or undersupplied capital markets will be able to accept a lower financial return than they could obtain in investments with similar risk, liquidity, subordination, size, and other financial

characteristics (or, equivalently, accepting the same financial return but with more risk, less liquidity, etc.) in order to generate certain kinds of impact (e.g., a cross-subsidization business model that enables access to a critical product or service to an underserved portion of the population).

We undertook updates to these definitions for several reasons:

- To encourage broader uptake of the terms and concepts by investors;
- To account for negative impacts and systematic risks;
- To shorten and simplify the names of the strategies;
- To more clearly distinguish investor contribution that causes (or is expected to cause) changes in outcomes for end-stakeholders and the natural environment from 'signaling that impact matters,' which by definition does not;
- To add a distinction between engagement that causes (or is expected to cause) changes in outcomes for end-stakeholders from engagement that does not;
- To expand the definitions to include collaborative investment and engagement; and
- To expand the definitions to include catalytic investment and engagement that unlocks third-party capital.

In Q3 2022 Impact Frontiers and PDI invited submissions of bespoke investor contribution metrics already in use by impact investors and conducted a desk review of several existing industry resources that included metrics. This resulted in a [set of metrics](#) collected from 18 investors and eight industry resources.

However, investors may not find exactly the metric that they need in this reference set, for several reasons.

Firstly, we observed that in almost all cases, bespoke metrics submitted by investors include some but not all of the elements of a complete accounting of how an investor's activity resulted in a change in outcomes for stakeholders that likely would not have occurred otherwise. When broken down into its component parts, we found that a comprehensive definition of investor contribution involves an accounting of:

- Investor actions
- Investor-level counterfactual (i.e., what would the company likely otherwise have received from investors)
- Change in company activities (scale and/or type),
- Company-level counterfactual (i.e., what would the company likely otherwise have done)
- Change in outcomes for end-stakeholders and the natural environment
- Stakeholder-level counterfactual (i.e., what would stakeholders and the natural environment likely otherwise have experienced)

Existing bespoke metrics vary widely in which of these data categories they address. Investors need to consider each of these elements to assess whether their activities have caused or are expected to cause a change in stakeholder outcomes that wouldn't have likely occurred otherwise.

Doing so may not be practical for every investor and/or for every investment. In the absence of a consideration of one or more of these elements, however, investors will not be able to form a robust view of whether or not their activities have caused or are expected to cause a change in stakeholder outcomes that wouldn't have occurred otherwise. As such, a primary goal of this project has been to develop resources that investors can use to calibrate their claims of investor contribution to their evidence for/confidence in their assessment of each of these elements.

More generally, the metrics in the reference set vary widely in terms of:

- Focus on asset owner, asset manager, company, or stakeholder level
- Focus on activities, outputs, outcomes, or impacts
- Within impacts, defining of the metric to 1) explicitly reference likely counterfactual versus 2) reference the company characteristics or contexts that imply a likely counterfactual but do not explicitly state it
  - Example of a metric definition that explicitly includes a likely counterfactual: "lent an amount that the company likely otherwise could not obtain"
  - Example of a metric definition in which a likely counterfactual is implied by company characteristics or contexts: "lent to an agricultural company with revenues under \$500k in Country X"
- Focus on particular impact themes that investors intend to advance via their contribution (especially engagement, e.g., "provided technical assistance to improve gender inclusion" versus "provided technical assistance to reduce environmental footprint")

Given all of the possible combinations of the above factors (plus asset classes and investment versus engagement strategies), the number of possible measures of positive investor contribution to impact quickly multiplies out of control.

These observations suggested to us that it may be premature to create a small set of standardized metrics for investor contribution at this stage of industry development. We have made the [reference set of metrics](#) available alongside the proposed templates, which investors can use to create context-specific measures of investor contribution that account for each of the six elements named above.

For a narrative explanation of this part of our research and findings, see this [video](#).