



# Contracts with (Social) Benefits: The Implementation of Impact Investing

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# Summary

- This paper examines the legal contracts of **impact funds** – funds that aim to generate specific beneficial social or environmental effects in addition to financial gains.
- The paper investigates both the contracts between the General Partners (**GP**) and the Limited Partners (**LM**) and also between the GP and the Portfolio Company (**PC**), and compares the contracts of market-rate-seeking impact funds (**MRS**) with none MRS impact funds (**NMRS**), and impact funds with non-impact funds.
- The paper documents that in some ways, non-impact funds and impact funds are **similar** -- for example both funds tend not to tie **compensation** to **impact** outcomes and tie compensation to **financial** performance and have a **waterfall** compensation structure.
- However, in some ways impact funds' contracts **differ** from those of non-impact funds, for example they are less involved in **governing** the PC: they have fewer **board** seats, and they are substantially less likely to have **voting** control.

# Overall Assessment

- This is a nice and important paper on a timely topic. The paper and its appendixes include extensive information on the contracting mechanisms of impact funds.
- My main comments will be about how to make the paper even more accessible and interesting for the reader.

# I. Adding Examples

(Julian Franks)

- Include examples from the contracts demonstrating each item.
  - For example, the paper says “While it is perhaps not surprising to see that impact funds contract on impact, it is interesting to see *how* they do so, and how MRS and NMRS funds compare. In the Panel B breakout of operational terms, the most common for both MRS and NMRS are **building impact into the diligence process** and **measuring impact**, both examples of flexible contract terms.”
- Include a brief example that demonstrates what “building impact into the diligence process” and “measuring impact” means.

I acknowledge that Table 4 and the internet appendix does this for a subset of the terms discussed. But I think having this for most terms discussed in the body of the paper would be very helpful especially since I assume the **target audience** of the paper is finance academics who are mostly not familiar with such terms.

## II. Providing More Interpretation of the Results in the Discussion

- Example: “The biggest differences between the types are that 32% of MRS funds commit to international ESG standards, 13 but only 15% of NMRS”. I would expect this result to be in the other direction, it would be helpful to have a brief discussion on the interpretation of this result.

Panel B: Break-out of impact terms

	Score weight	<u>Incidence (% funds)</u>			Difference NMRS-MRS
		All	MRS	NMRS	
<u>Aspirational impact terms</u>					
Social impact addressed in agreement	1	94%	92%	100%	7.9%
Agreement generally prohibits negative impact	1	60%	58%	62%	3.6%
Fund commitment to social impact	} 1 if either	83%	84%	77%	-7.3%
Fund commitment to environmental impact		62%	63%	54%	-9.3%
<u>Operational impact terms</u>					
Fund commitment to international ESG standards	0.5	30%	32%	15%	-16.2%

# III. Comparison of Impact vs. Non-impact Funds

- Conducting the **impact vs. non impact comparison** is perhaps one of the most interesting parts of the paper because we already know about how hedge funds and private equity funds contract, thus they can serve as a benchmark for what is customary.
- The limitation of the comparison analysis is that it compares findings of other papers that use data from **one-two decades** ago for non impact funds to **current** data on impact fund, which may not be comparing apples to apples. In addition, the data of the other papers may be **coded** somewhat differently, and thus may not be comparable.
- Perhaps it would be possible to obtain data for a small set of non-impact funds to allow a clearer comparison?
- If the latter is not possible, I would recommend arguing that if a linear relation is found from impact-NMRS-MRS funds for a given measure, that likely indicates that there exists a relation between the type of fund and the contract mechanism.

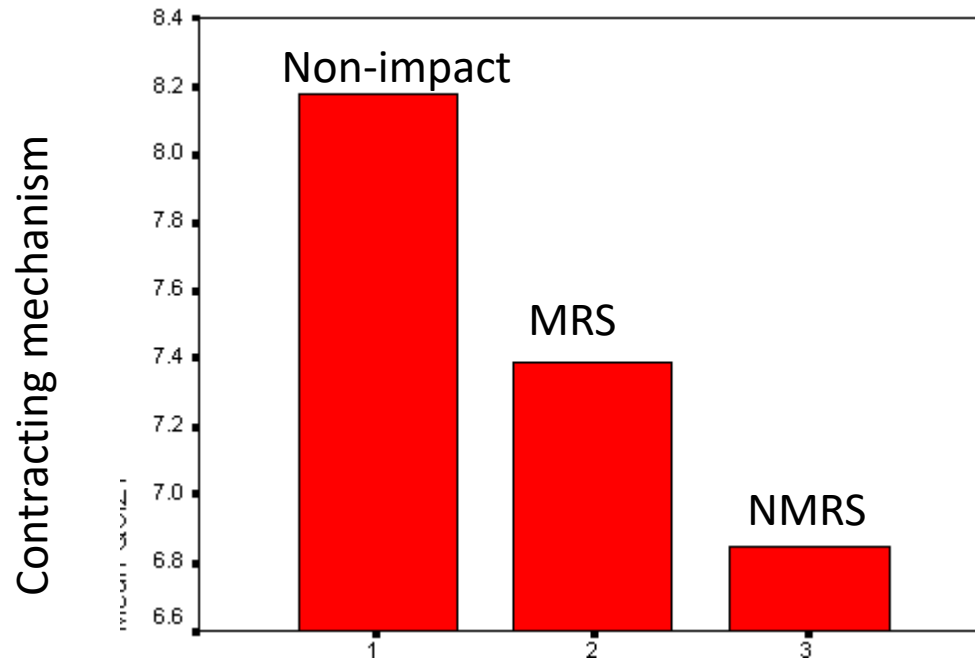
# III. Comparison of Impact vs. Non-impact Funds

**Table 10: GP Compensation**

This table presents a comparison of the compensation terms observed for impact funds, relative to non-impact funds documented by Metrick & Yasuda (2010) (MY) and Gompers & Lerner (1999) (GL '99). The incidence rate is defined as the percent of funds with a non-zero value for the term in question. The mode and range are only reported for these non-zero values. For the management fee break-outs, funds with no management fees are counted in the "<2%" group. It is reproduced for small and large funds in Tables IA-9 and IA-10, and for the Metrick & Yasuda time period in Table IA-15.

	Non-impact		All	Impact		Difference NMRS-MRS
	Reference	Non-impact		MRS	NMRS	
<u>Waterfall</u>						
Incidence	MY (VC+PE)	100%	85%	87%	77%	-9.9%
<u>Hurdle rate</u>						
Incidence	MY (VC)	45%	58%	61%	46%	-14.4%
	MY (PE)	92%				
Mode	MY (VC)	8%	8%	8%	10%	
	MY (PE)	8%				
Range	MY (VC+PE)	6-10%	3-10%	5-10%	3-10%	

# III. Hypothetical Example





# IV. Financial Performance

- From the publication “*Great Expectations: Mission Preservation and Financial Performance in Impact Investing*” I understand that the authors have data on financial performance.
- It would be nice if correlations between the major contracting mechanisms/scores and financial performance could be reported. This could provide an indication of the potential financial cost or benefit of each component for different types of funds.

# V. Construction of the Impact Measure

- Measure construction: it would be helpful to explain:
  - How were the items chosen?
  - How were the weights chosen (e.g., below weights range -0.25-1)?

**Manager restrictions** — This score captures restrictions imposed on managers, such as fiduciary duty, ability to reinvest funds, and manager's outside activities.

Scoring notes: High importance terms have a weight of 1; medium importance terms a weight of .5; and low importance terms a weight of .25. If the term *removes* restrictions for the manager (or gives explicit permission for discretion), then the score is negative.

Question	Weight	Mean
Does the manager have a non-compete with the fund?	0.5	43.4%
Did the manager sign a confidentiality agreement with the fund?	0.5	20.8%
Does the Manager owe fiduciary duties to the fund?	1	52.8%
Can the Manager co-invest with the fund?	-0.5	49.1%
Can Managers reinvest fund profits?	-0.25	69.8%
Is the fund GP/Manager restricted on outside fund raising?	1	28.3%
Is the GP/Managers prohibited from activity outside of the fund?	1	35.8%
Does the agreement restrict asset investments in which GP/Manager has little experience?	0.25	0.0%

# VI. Do Impact Funds Actually Push Social Issues?

Are the actions of impact funds aligned with what they state?

- Are impact funds more likely to vote in support of environmental issues at shareholder meetings.
- Is there any evidence that in “regular” companies (e.g., high tech) impact funds push social issues?

# Minor Comments

1. How are funds classified as MRS or NMRS? The bottom of p. 5 specifies 5 options, but does not state which of the 5 options were used for MRS vs. NMRS.
2. It would be helpful if the descriptions of the tables would be more detailed.
3. I would recommend including the summaries on the regions and industries in which impact funds invest in the paper rather than the appendix. I think this table/figure is important because it demonstrates how these funds implement impact investing in practice.

**Thank You for Your Attention**