IMPACT INVESTING & GREENWASHING – WHY MEASUREMENT MATTERS

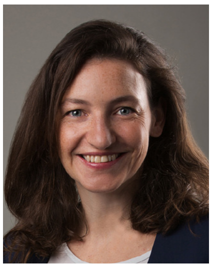
ISOBEL MORTON AND EMMA GARNHAM – WWW.MACFARLANES.COM

One solution to both the risk of greenwashing and the need to balance financial and non-financial factors when investing is ensuring you can measure the impact. But what does that mean?

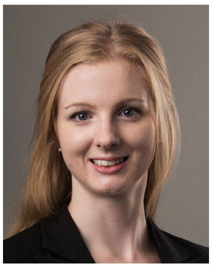
ESG investing is big news: from media headlines to new product launches to regulatory developments, there is significant focus on whether non-financial metrics can contribute to a better world and how such opportunities are marketed. On the ESG spectrum, a step below philanthropy is the concept of impact investment: investments made with the intention to generate positive, measurable social and/or environmental impact alongside a financial return. Will the reality live up to the claims, or are we facing a barrage of greenwashing, with claims of ESG credentials unsupported or unproven? How do we measure 'success' when it comes to the assessment of non-financial outcomes?

Fiduciaries are being asked to balance beneficiary expectations and mandates for impact with a rapidly expanding and elegantly presented array of impact investment opportunities. How to digest the marketing, deliver on mandates and comply with their duties? There is an ongoing debate taking place about the extent to which charitable (and other) fiduciaries can take non-financial factors into account when exercising a power to invest, but the Charity Commission has been clear in its recently updated guidance that there will be instances where this is appropriate. What is clear is that any non-financial intended impact of an investment will need to be clearly identified (and justified in light of broader fiduciary duties) and subject to ongoing assessment.

One solution to both greenwashing risk and fiduciaries' balancing act is therefore ensuring you can measure the impact. But what does that mean?



ISOBEL MORTON



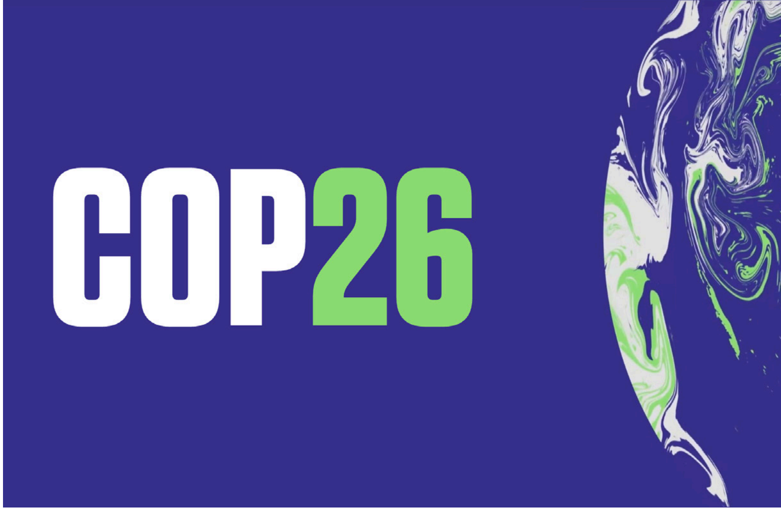
EMMA GARNHAM

THE INVESTMENT PROCESS

The first question is: what is going be to measured? When considering the myriad of impact investment opportunities on offer, a clear, well-defined mandate for particular impacts is the first step towards having an impact that can be measured and an investment decision that is defensible, and an essential step in discharging fiduciary duties. A clear mandate will narrow the investable universe, save time and cost in diligencing and evaluating opportunities, and reduce the risk of being greenwashed.

With a clear mandate in place, how to evaluate impact investments? Critically, the initial evaluation is not just about the usual due diligence exercise but also sets the baseline for measuring an investment's impact over its holding period.

> *"THE RECENTLY ANNOUNCED CREATION OF AN INTERNATIONAL SUSTAINABILITY STANDARDS BOARD (ISSB) AT COP26 IS INTENDED TO PROVIDE GLOBALLY ALIGNED AND ACCEPTED SUSTAINABILITY REPORTING STANDARDS."*



Fiduciaries considering impact investments should ensure a sound baseline is recorded in order to discharge their fiduciary duties.

When considering what a baseline should be, look back to the heart of impact investing — something that has a positive, measurable social or environmental impact. For example, we can measure, and see the positive impact of, the number of affordable housing units delivered to families living below the poverty line in a given year. We can also measure, and experience, the positive impact of replacing 1,000 megawatts of coal-fired electricity with 1,000 megawatts of wind-powered energy. And, over time, we can measure the change to these metrics — 10 per cent more housing units, 500 more megawatts of power by wind. Clear baselines like these make it easier to spot greenwashing — have the houses been delivered? Has the coal been replaced with wind turbines?

After investments are made, fiduciary duties and any mandate-specific reporting obligations dictate the need for appropriate ongoing monitoring and evaluation — also ensuring the initial investment was not mis-sold or greenwashed. But how to monitor and evaluate impact investments? This is where a clear baseline combined with quality data sources is needed to enable measurement of desired impacts.

TOOLS FOR FIDUCIARIES

The second question is: how to measure the impact? The short answer: good data collection.

Regulatory developments such as the Regulation (EU) 2019/2088 of the European Parliament and of the Council of 27 November 2019 on sustainability-related disclosures in the financial services sector (known as the SFDR) and the United Kingdom's own recently announced (but not yet enacted) Sustainability Disclosure Requirements (known as the SDR) can help with both initial evaluation and ongoing monitoring. The primary goal of these regulatory regimes, and supplementary regimes currently being developed, is to prevent greenwashing by prescribing easily comparable pre-contractual disclosures and ongoing reporting requirements. From 2022, for the SFDR, and post-2022, for the SDR, annual reporting of certain sustainability indicators and principal adverse impacts on sustainability measures will be required. Depending on the nature of the impacts investors are targeting, they may find this regulatory reporting a useful source for collecting the relevant data to measure impacts.

The recently announced creation of an International Sustainability Standards Board (ISSB) at COP26 is intended to provide globally aligned and accepted sustainability reporting standards. Globally aligned standards will be a powerful tool, particularly in the hands of investors with global portfolios, and it is hoped will help to mitigate some of the challenges posed by existing disparate regulatory and voluntary disclosure and reporting frameworks. However, this is still in development and challenges remain in the interim.

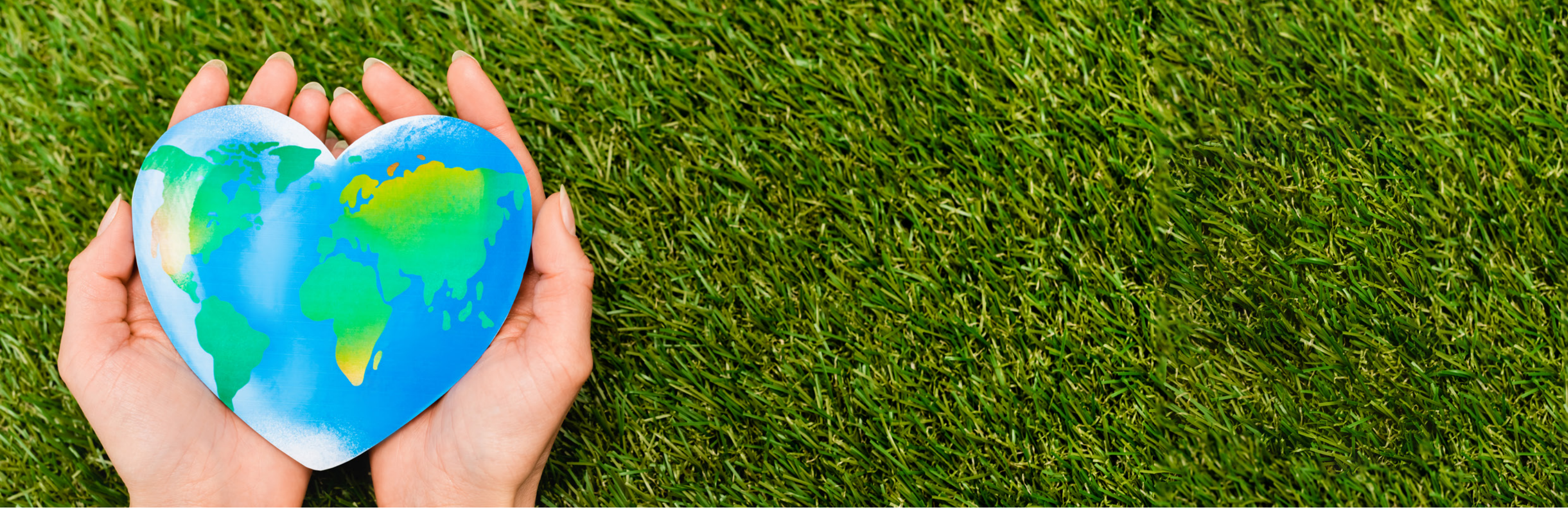
Another powerful tool is the dedicated impact investment due diligence questionnaire (DDQ). A tailored impact DDQ can support clear baselines (key at the investment evaluation phase) and provide an ongoing source of data for measuring non-financial performance (or non-performance) against impact objectives. Similarly, a side letter with mandated reporting may achieve a similar outcome if appropriately negotiated.

ISOBEL MORTON – PARTNER AND HEAD OF ESG, MACFARLANES

Isobel is the partner responsible for the firm's strategy relating to environmental, social and governance (ESG) issues, with a particular focus on environmental sustainability. Prior to taking on this role in May 2021, Isobel had 13 years' experience as a Private Client Lawyer at the firm, spending three years as a partner. Isobel has oversight of the ESG-related work being undertaken across the firm is chair of Macfarlanes' ESG steering committee.

Prior to taking on an ESG-focused role, Isobel advised on a wide range of tax and estate planning issues for domestic and international clients. She developed a particular focus on emerging approaches to wealth management.

Isobel is the partner champion for the environmental committee, which leads the firm's sustainable business agenda, and also for the company's Balance network, a forum providing networking and peer support for all staff managing careers and home lives, to achieve a sustainable work-life balance. She is also a trained mentor for the firm's mentoring schemes.



COMMON MEASUREMENT CHALLENGES

The third question, then, is: what if we cannot source 'good' data? Well, that is not the end.

The underlying data needed to measure and evaluate impacts is not always readily available. As a rule of thumb, be sceptical of products or service providers who are unable to support at least a basic impact DDQ or meet most regulatory reporting requirements under the SFDR for their investment opportunity. Where underlying data is not available today, do not be afraid to ask questions: why not? What is the plan to collect this? Are there reasonable, verifiable estimates? Not all impacts are measurable today, but that does not mean this will be the same tomorrow.

"BUT FOREWARNED IS FOREARMED; AN INVESTOR MAY CONSIDER REQUESTING THE DATA UNDERLYING SUCH REGULATORY REPORTING TO MAKE THEIR OWN COMPARISONS."

The SFDR and SDR originate from the same desire — to prevent greenwashing. But that will not stop the European Union and United Kingdom regulatory requirements for ESG and impact-oriented products and services diverging. Be conscious that as regulatory divergence grows, so too does comparability complexity of prescribed reporting data – you may end up comparing apples in England with *les pommes de terre* in France. But forewarned is forearmed; an investor may consider requesting the data underlying such regulatory reporting to make their own comparisons. However, this may be a shortlived fear — the creation of the ISSB suggests a global appreciation of the power of comparable data and reporting as a tool to prevent greenwashing and inform better ESG and impact investment decision-making.

When considering whether to pursue measurable data beyond what is readily provided through regulatory reporting and DDQs, fiduciaries should be mindful of costs, as data collection, verification and analysis costs may become disproportionate.

True impact investments can contribute to a better world. To ensure the impact investments selected are not just greenwashing and marketing puffery, of which failure to identify would risk breaching fiduciary duties, investors should evaluate and monitor impact claims against positive, measurable metrics as far as possible. Measuring your impact — that is a quantifiable contribution to a better world.

EMMA GARNHAM – NEW ZEALAND-QUALIFIED LAWYER, MACFARLANES

Emma advises clients in all aspects of work relating to both regulated and unregulated funds and has advised managers on fund formation, and institutional investors on investments into private equity and hedge funds.

In addition to advice on the structuring, establishment and operation of investment funds, Emma also assists clients with investment management agreements, depositary agreements, platform and distribution arrangements. She also advises clients in relation to ongoing regulatory matters, including the application of the UCITS directive, AIFMD, MiFID II and the Benchmarks Regulation.

Emma has previously spent time on secondment with Goldman Sachs International.