西村あさひ法律事務所

Overview of Legal Issues Relating to Impact Investing

Corporate Newsletter

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1. Introduction

In September 2015, the United Nations adopted the Sustainable Development Goals (SDGs) as part of the "2030 Agenda for Sustainable Development". In pursuit of and in parallel with these global goals, countries around the world are moving rapidly to resolve social issues such as poverty and environmental degradation.

Given these trends, there has been growing international attention in "impact investing," a form of investment that aims to resolve social issues via social and environmental influence of the investee. However, the concept of impact investing has yet to be embraced fully by Japanese investors, and it cannot be said that the legal issues regarding impact investing are well-understood in Japan. This newsletter explains the basic concept of impact investing and provides an overview of the potentially problematic legal issues that can arise in impact investing.

2. What is impact investing?

The term “Impact Investing” (or “Impact Investment”) does not have a formal legal definition; however, the Global Impact Investing Network (GIIN), a non-profit organization established in 2009 by investors like the Rockefeller Foundation, defines it as follows: “investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return,” which is used frequently in this area, and is the definition relied upon in this article.

Impact investing differs from pure donation, in that it intends to obtain a financial return (return expectation). In addition, "impact" refers to positive and measurable social and/or environmental changes and effects (positive impacts) that occur as a result of the relevant business or activities; these impacts may be either short-term or long-term. Impact investing has different characteristics from ESG investment, which aims to improve investment efficiency through negative screening of companies that are at risk due to ESG factors, in that impact investors have an intention to create a positive impact through the companies in which they invest (intentionality). From a macro perspective, impact investment can be regarded as being aimed at solving external diseconomies, such as environmental problems caused by market activities, which traditionally would be expected to be resolved through tighter government regulations and public policies, such as subsidies; impact investing seeks to resolve these diseconomies by utilizing private funds (including dormant deposits) seeking financial returns.

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The impact investing market is expanding globally, with an estimated investment total of approximately $715 billion worldwide in 2020[1]. During the same period, it is estimated that there were approximately 1,720 impact investors, including highly social funds such as international development financial institutions, regional development financial institutions, and family offices. This base is expanding to include investors who place importance on profitability, such as private equity funds (PE), venture capital funds (VC), pension funds, investment trusts, insurance companies, and corporations. While each may have their own specific concerns, generally, impact investor are interested in solving social issues, such as decarbonization, renewable energy, agriculture, microfinance, healthcare, medical / biotechnology, and education, through investment in various targets, such as private equity / public equity, private debt / public debt, and real estate.

In 2021, the impact investing market in Japan was considered small, with an estimated investment balance of about 1320.4 billion yen.[2] However, on November 29, 2021, the Social Impact Investment Foundation declared that impact-oriented investment and financing should be practiced by financial institutions such as banks, life insurance companies, and VC. This Japan Impact-driven Financing Initiative has been signed by various financial institutions, revealing an expectation of gradual expansion for the impact investing market.

Although impact investment is growing rapidly across the globe, there are many challenges to ensuring its continuing spread. One of the largest challenges is how to measure impact. To make appropriate investment decisions as an impact investor, impacts have to be measurable so that the risks, returns and impacts can be evaluated against one another in an objective and comparable way (for example, by conversion to monetary value). Unfortunately, quantifying such metrics is no easy task, especially given that an investment's impacts cannot be simply measured in objective metrics and the range of benefit can be indefinite, as it can be expanded from a project's targeted beneficiaries to society as a whole (or even be accompanied by a new/unexpected set of negative externalities). Various attempts to measure and disclose impacts objectively have been studied, but there is no established method, and this is perhaps the most significant issue facing the spread of impact investing.

3. Legal Issues of Impact Investment

(1) Impact investment and fiduciary duty

Generally, a person entrusted to exercise discretionary authority over the management of another person's funds owes a fiduciary duty to that other person that typically (either explicitly or tacitly) entails maximization of that person's financial interests. As stated above, the intention of impact investing is not just to obtain a financial return, but rather to obtain both a financial return and a positive outcome. Therefore, the question arises whether there is a potential breach of fiduciary duty when asset owners such as pension funds, mutual funds and insurance companies make impact investments, or when investment managers (asset managers) entrusted by such asset owners make impact investments that may forgo financial maximization.

Similar discussions can be found in the context of ESG investment, which questions whether it is contrary to fiduciary duty if investment returns are sacrificed as a result of taking ESG factors into account, resulting in investment performance that is below market returns, or rather whether it is a breach of fiduciary duty if ESG factors are not taken into account. In Japan, general consensus is moving in the direction of promoting

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[1] Global Impact Investing Network "Annual Impact Investor Survey 2020" 2020, pp.40 (https://thegiin.org/assets/GIIN%20Annual%20Impact%20Investor%20Survey%202020.pdf)

[2] GSG-NAB Japan "The Current State and Challenges of Impact Investing in Japan" FY2021 Survey, pp.45 (http://impactinvestment.jp/user/media/resources-pdf/gsg-2021.pdf)

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consideration of ESG factors on the basis that the considering of ESG factors in itself does not immediately trigger issues of breach of fiduciary responsibility (particularly the duty of care). This perspective is supported by Japan's Stewardship Code, revised in March 2020, that requires institutional investors to consider sustainability, including ESG factors, in their investment activities as part of their stewardship responsibility. Of course, careful consideration will be required in regards to this question given the regulatory laws and guidelines applicable to each asset owner and asset manager, as well as the management strategy and the contracts of each investor. In this respect, while it can be presumed that each impact investor, who owes a fiduciary duty, has considered these legal issues, there has not yet been sufficient global discussion of such matters.[3] As such, further discussion is necessary regarding whether it is acceptable to consider factors other than monetary return in the interpretation of fiduciary duty, and whether it is acceptable to make a trade-off between the impact pursued and monetary return.

Further, the fiduciary duty of directors (in Japan, the *zenkanchui-gimu*) can be an issue for the investee company of impact investment, in terms of whether it is acceptable for directors of a company aiming to create an impact to make management decisions that do not maximize shareholder profit as a result of pursuing a desirable social impact.

This point also has been discussed in the context of whether commercial companies can engage in CSR activities or make management decisions in consideration of ESG factors without the potential risk of breaching the fiduciary duty of directors. These discussions have recently increased in prominence globally as part of the wider debate concerning "the purpose of companies." Directors of Japanese stock companies are obliged to comply with any statutory duties applicable, and therefore, as long as they comply with the relevant laws and regulations, there is basically no question of a breach of fiduciary duty. On the other hand, as it is envisaged that policies promoting social well-being are increasingly becoming part of overseas regulations or soft laws (e.g. government or industry guidelines) to which Japanese companies may not be directly subject (but nonetheless may hold some sway), it may be necessary to discuss the effects to directors' fiduciary duties in cases where the directors follow such policies.

(2) Impact investment and company forms

In Japan, commercial organizations such as stock companies and limited liability companies, as well as non-profit organizations (NPOs) such as incorporated associations and foundations, are generally chosen as the organizational forms for social enterprises. However, there are limitations to these forms, such as that they generally cannot raise funds from investors seeking returns (in the case of NPOs), may have certain limitations on conducting social business at the sacrifice of profitability (including the issue of directors' fiduciary duties in the case of commercial organizations), and it is not easy to transition between the two.

In this regard, it is noteworthy that other countries have introduced corporate forms that allow both commercial and non-profit operations. For example, in the United States, since the Public Benefit Corporation (PBC) corporate form was recognized in some states in 2010, it has been actively used by social enterprises. The PBC was created to respond to the need to pursue public benefit as well as economic profit and is unique in that directors are not necessarily obligated to maximize only shareholder profit (in other words, there is room for management decisions that do not maximize shareholder profit but do not breach the fiduciary duty of directors). This means that a manager who intends to conduct "social business" can avoid shareholder claims of fiduciary duty breach for not maximizing financial returns by adopting the PBC corporate form. Thus,

[3] In this regard, Principles for Responsible Investment (PRI) has published "A Legal Framework for Impact: Sustainability impact in investor decision-making" (https://www.unpri.org/download?ac=13902).

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creating a special corporate form in Japan, similar to the PBC, may be a potential means of preventing a mismatch between some companies' missions and their funders' goals and interests, making it worthy of further discussion.

Furthermore, the effect of stipulating sustainability-related matters in a company's articles of incorporation (*teikan*) is also a point of contention. For example, there have been cases of companies amending their articles of incorporation to include SDG-related matters in the purpose provisions of their articles of incorporation without changing the form of their stock company structure. It will be necessary to deepen the discussion on the specific obligations of directors in relation to their duty to comply with the articles of incorporation (article 355 of the Companies Act).

(3) Impact investing methodology and documentation

In Japan, the most common method of impact investing is acquiring shares in the investee company (if the company is a stock company). It is also possible for an investor to become a debt holder by lending money or underwriting bonds. In addition, crowdfunding using the anonymous association ((in Japan, tokumeikumiai) investment method may be used to raise funds from a large number of general investors, including individuals.
While there are various investment methods that can be used for impact investing, the key point is the content of the contracts that are concluded for these investments. For example, assuming a case where a VC or PE company forms an impact investing fund to invest in unlisted stocks and also provides hands-on management support, at the least, it is necessary to enter into an LP agreement regarding the formation of the impact investing fund, an investment agreement with the investee company regarding the impact investing, and a shareholder agreement with the existing shareholders of the investee company. In some cases, a management delegation agreement may also be necessary.

While these agreements are required for ordinary investment projects, there are likely to be some provisions that require consideration that are specific to impact investing. As an example, for an LP agreement, the duration of the fund, the expected role of the fund manager in realizing impact, the mechanism for allocating returns to the GP, matters related to the investment strategy including the portfolio of investee companies, and the disclosure of information to the LP regarding the status of impact realization of the investee company, etc., are likely to differ in many respects from those of ordinary VC or PE. In addition, with regard to investment agreements and shareholder agreements, there may be issues such as the purpose of the investment, measures to prevent mission drift (a situation in which actual corporate operations are diverted away from the company's purpose and mission), monitoring and disclosure regarding the status of impact realization of the investee company, KPIs related to impact evaluation, exit methods and timing (in particular, ensuring exit options, including dealing with mission drift, and ensuring the realization of impact even after the investor exits, etc.), and design of incentives for executives of the investee company.

When impact investing in private companies in Japan, impact investing funds often do not become lead investors unless entering at the seed stage. Therefore, in such cases, it is not easy for impact investing funds to proactively include the desired provisions in the investment agreement or shareholder agreement. Thus, it is important for impact investing funds to make certain arrangements with the investee company, such as by concluding side letters with it.
On the other hand, in the case of seed stage investments, it may be possible for the impact investing fund to act as the lead investor and play a leading role where entering into agreements with the investee company. However, in this case, the impact investor's insistence on the initial business concept of the investee company may deprive the startup of the flexibility to manage its business in the early stages, when the business can

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easily pivot. Therefore, if impact investing funds become lead investors, they will need to be flexible so as not to hinder fundraising from outside investors later on.

(4) Impact investing and Due Diligence

Since impact investing focuses on both financial return and impact, financial evaluation and impact evaluation are also important in the Due Diligence that precedes the investment decision. When impact investors are considering investment decisions, certain “hurdle rates” should be identified for both financial return and impact, and the investment decision should only be approved when both criteria are met.

From the perspective of Due Diligence, in addition to investigating matters that are subject to confirmation in ordinary investment projects, it is particularly important to verify the realization of outcomes using a “logic model” and a “theory of change” framework via Due Diligence that focuses on impact, which is the most important feature of impact investing. In addition, a “Five Dimensions of Impact ” of impact is often utilized to evaluate the impact created by the investee company's business from multiple perspectives. In this case, the impact investor sets impact KPIs that are important to the investee company and determines the situation at the time of investment and the prospects for future improvement and enhancement through impact Due Diligence. Based on these Due Diligence results, it is desirable to make certain allowances in investment agreements or shareholders agreements to ensure that the financial return and impact will be realized as expected. In addition, although impact investing itself is not necessarily an ESG-focused investment approach, surveys on ESG risks (especially in recent years, the importance of “S” is emphasized) are often conducted in conjunction with such Due Diligence as there are related issues in common.

(5) Impact Investment and Exit

When engaging in impact investing, particularly in unlisted startups, it is important to consider exit strategies. The main exit options for startups are generally M&A or IPO. This is not significantly different for social enterprises.

Nevertheless, a social enterprise entering a growth phase and then deciding to exit must consider the aforementioned mission drift issue. In other words, depending on the management policies of the acquired company after the change of ownership, the objectives and mission that the acquired company has focused on may be abandoned and the management may shift to one that focuses more on profitability. It is also possible that even after an IPO, the acquired company will be pressured by shareholder proposals and other methods from general shareholders to change to a management style which focuses more on profitability. Fearing shareholder lawsuits, the company may be forced to switch to a more profit-oriented management style.

In the case of a M&A, an acquiring company can be prevented from adopting a management style that over emphasizes profitability to some extent by ensuring in the acquisition agreement that the acquiring company pledges a certain commitment to post-acquisition management. In the context of an IPO, on the other hand, such arrangement may be impractical as the interests of a larger number of shareholders need to be taken into account.

Other countries have undertaken interesting initiatives in this regard. Several countries provide platforms (so-called social stock exchanges) for investors to trade shares of socially responsible companies. Although the institutional design of such stock trading mechanisms and their position in the securities market differ from

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country to country, the purpose of the platform is to facilitate the matching of impact-oriented investors with social businesses, under different regulations than those required by regular stock exchanges.

Also, there are examples of IPOs of PBCs as well as companies that are certified as B Corp by B Lab, a non-profit organization, while still having a for-profit corporate form. Although B Corp is not an official certification system, it is used worldwide and has certain stringent requirements. B Corp, as a result, is expected to have a signaling effect, indicating to a wide range of stakeholders, including potential shareholders, that a company aims to consider the interests of stakeholders as a whole, not just that of shareholders.

Since there is no IPO system for only social business enterprises, social businesses are required to proceed through an IPO in the normal way. In Japan for example, it is noteworthy that some companies limit the use of funds raised to SDG-related issues by obtaining a second party opinion (SPO) from an external evaluation institution on the company's compliance with the Social Bond Principles released by the International Capital Markets Association and the ESG initiatives, and some other companies begin to plan IPOs in the Japanese securities market after obtaining B Corps certification. In order for similar initiatives to spread in Japan in the future, it is necessary to reduce the cost burden of obtaining external evaluations and B Corp arrangements as possible, and increase the number of investors who place importance on such initiatives in their investment decisions.

In the case of an IPO by an impact-oriented company, systematic considerations will be required. For example, how to disclose expected impact and financial return, as well as the risks associated with them, in the annual securities report (section I)/annual securities registration statement/prospectus or, in the case of a company seeking to list on a growth market, how to disclose such information as part of the "business plan and growth potential matters."

4. Conclusion

Although impact investing is still in its infancy in Japan, if more and more successful projects are conducted, this will lead to an ecosystem that embraces impact investing expanding overseas. The establishment of a legal framework will be crucial to promoting impact investment.

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