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Hamburg Sustainable Finance Paper Series

Working Paper

Regulating Impact Investments: An Exploration of the Influence of the EU Taxonomy and SFDR on Impact Funds Strategies and Impact Measurement Practices

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Hamburg, October 23, 2024

HSF-Paper-02

Published by:
Sustainable Finance Research Group e.V. ----- www.sfrg.org
Finance Impact Research Sustainability Transparency e.V. ----- www.first-ev.org
University of Hamburg ----- www.uni-hamburg.de

ABSTRACT

Impact investments hold promise as a vehicle for addressing global social and environmental challenges, but their effectiveness hinges on robust regulatory frameworks and accurate impact measurement practices. With two central research questions, this paper sheds light on critical aspects within the context of European impact funds. In the current version of the European regulatory framework, the concepts of impact and transition are underrepresented. We thus seek to derive recommendations on how to improve EU regulatory efforts. In order to do so, we pose two research questions: 1) How does the European Sustainable Finance Framework, specifically the EU Taxonomy and the Sustainable Finance Disclosure Regulation (SFDR), influence the strategies and operational structures of impact funds? and 2) How do fund managers currently measure the impact of their impact investment products and how could regulation support and enhance such efforts? Our exploratory research shows that, despite an increasing interest in impact products, ambiguity persists in defining and reporting impact. While the EU regulations have not drastically changed impact fund strategies, they have prompted significant operational shifts to maintain impact integrity. In addition, effective measurement is crucial for credibility. Our research reveals that impact fund managers call for enhanced impact reporting frameworks and advocate for very specific mandatory regulations to improve impact measurement frameworks. In sum, this paper highlights the need for regulatory clarity and consistency in the European frameworks via a classification of sustainability-related investments and effective measurement guidelines in order to ensure that impact investment vehicles fulfill their promises.

1. Introduction

Impact investing, an investment style that considers not only financial returns but also the social and ecological consequences of money attribution and allocation, has recently gained a lot of attention from a variety of actors in the sustainable finance world (policy makers, investors and scholars, among others). These actors see impact investing as having the potential to stimulate the uptake of sustainable investments by leveraging additional private funding, in particular by financing long-term investments in sustainable economic activities and projects, and thereby fostering positive change towards a more sustainable and equitable global economy (Eurosif, 2022; European Commission, 2020; Grimes et al., 2019; Höchstädter and Scheck, 2015; Logue and Grimes, 2022). However, the wide acceptance of the impact investment definition—investment made with the intention of generating measurable positive social and environmental impact alongside financial returns (GIIN, 2023)—does not help reduce the potential for misunderstanding and confusion around such investment products. Financial market participants are often tempted to boast about their impact investment products, possibly leading to impact washing (Busch et al., 2021). Given the growth of impact funds and the surge in global assets under management in this sector (Hand et al., 2022; World Economic Forum, 2023), there is an even higher risk of impact washing.

In that regard, to meet the European Green Deal objectives, the European Commission (EC) recently introduced regulatory frameworks to stimulate the market, particularly private capital, to adopt sustainable investments (European Commission, 2019). Within these frameworks, the European Union (EU) Taxonomy Regulation and the Sustainable Finance Disclosure Regulation (SFDR) play pivotal roles in steering private capital towards sustainable investments. The EU Taxonomy serves as a classification tool for sustainable activities (Regulation 2020/852), and the SFDR ensures transparency in investors' sustainability considerations (Regulation 2019/2088). This is without doubt a major advancement in ensuring investor protection, investment control and market integrity for sustainable investments. However, these regulations lack clarity about what exactly is an impact investment product, and the absence of boundaries with clearly defined categories differentiating it from other sustainable investments may hinder the objectives of the European Green Deal.

If the key practical hurdle for the adoption of an impact investing approach is the measurement of the performance of impact, the risk that investors become anxious and much more cautious with their impact investing decisions is real. This may become a missed opportunity for the European Green Deal Investment Plan to finance the transition to a sustainable economy (European Commission, 2020). Impact investments are key financial instruments for the European Green Deal, but their success at EU level depends on effective implementation of the new European legal and regulatory initiatives and accurate impact measurement.

Consequently, two research questions emerge: 1) How does the European Sustainable Finance Framework, specifically the Sustainable Finance Disclosure Regulation (SFDR), influence the strategies and operational structures of impact funds? and 2) How do fund managers measure the impact of their impact investment products, and how could regulation support and enhance such efforts? This paper answers these two questions by focusing on European impact funds and using data collected through semi-structured interviews with impact funds' directors, managers and analysts across Europe, all actively involved with the EU regulatory framework. This research is exploratory and aims at seeking new insights for policy makers in the impact investing field within the EU sphere.

2. General Background

2.1 Impact Investing

Impact investing has emerged as a transformative and innovative force within the global financial landscape, targeting both financial returns and positive societal impact. Defined by the Global Impact Investment Network (GIIN) as "investments made with the intention to generate positive, measurable social and environmental impact alongside a financial return" (GIIN, 2023), impact investing pursues a dual objective that sets it distinctly apart from traditional investment strategies and pure philanthropic initiatives (Hehenberger et al., 2019; Höchstädter and Scheck, 2015; Martin, 2016; Weber, 2016). Impact investing, therefore, reflects a growing recognition of the interconnectedness of the financial performance and the environmental or social impact of investments (Busch et al. 2021; Schlütter et al., 2023). In this context, effective measurement of impact has become crucial to demonstrate accountability to investors, enhance credibility, and support capital flow into sectors such as renewable energy, green buildings or sustainable agriculture.

2.2 Regulatory Context: The EU Sustainable Finance Framework

The European Union has been at the forefront of integrating sustainability into its financial sector, a movement underscored by the establishment of the EU Sustainable Finance Framework, which serves as the bedrock upon which the EU Taxonomy and the SFDR have been developed (European Commission, 2023). These regulations and their delegated acts are all closely interconnected and rely on each other for the proper implementation and success of the EU Sustainable Finance Framework (Brühl, 2022). However, in the current version of this regulatory framework, the concepts of "impact" and "transition" are underrepresented, under-categorised, and insufficiently evaluated, with a disproportionate focus on climate-related issues. Furthermore, the immediate actions regarding the financing of the transition towards a sustainable real economy as listed in the Annex to the European

Commission's Communication on its "Strategy for Financing the Transition to a Sustainable Economy", have not yet been implemented or adequately communicated. These actions include:

1) Considering options to extend the EU Taxonomy framework to recognise transition efforts"

2) Extending sustainable finance standards and labels to support financing the transition to sustainability and phased transition efforts.

2.2.1 The EU Taxonomy Regulation

The Taxonomy Regulation (Regulation 2020/852) plays a pivotal role in introducing a unified, market-wide definition of "green investments" to counteract greenwashing[1]. The Taxonomy categorizes economic activities based on their contributions towards specific environmental objectives[2], while adhering to the 'do no significant harm' (DNSH) criteria.

However, the implementation of this regulation presents notable challenges for asset managers. The success of the Taxonomy in meeting its environmental objectives largely depends on corporate implementation and the ensuing quality of non-financial corporate disclosure (Bassen et al., 2021). However, the challenge arises from the need for detailed technical data regarding the environmental performance of the company's products or services, such as their energy efficiency, greenhouse gas (GHG) emission intensity, water intensity and more (Alessi & Battiston, 2022).

The development of technical screening criteria that accommodate a broad spectrum of activities while harmonizing different methodologies requires substantial resources and poses considerable challenges (Canfora et al., 2021). Another challenge asset managers encounter is aligning their existing frameworks for assessing portfolio greenness with the EU Taxonomy's criteria. The Taxonomy is one of the strictest measures for determining the greenness of a product or asset. Therefore, assets labelled as 'green' under other frameworks might not be fully Taxonomy-aligned, highlighting a potential discrepancy in green standards (Alessi & Battiston, 2022).

Currently, only a limited number of companies have the capacity to generate such data and it is expected to remain out of reach for many small and medium enterprises (SMEs). Additionally, non-EU

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[1] REGULATION (EU) 2020/852 on the establishment of a framework to facilitate sustainable investment: (11) Making available financial products which pursue environmentally sustainable objectives is an effective way of channeling private investments into sustainable activities. (…) greenwashing refers to the practice of gaining an unfair competitive advantage by marketing a financial product as environmentally friendly, when in fact basic environmental standards have not been met.

[2] The EU Taxonomy six key environmental objectives are: (i) climate change mitigation; (ii) climate change adaptation; (iii) sustainable use and protection of water and marine resources; (iv) transition to a circular economy; (v) pollution prevention and control; and (vi) protection and restoration of biodiversity and ecosystems.

firms, which are not mandated to disclose such information, are also unlikely to provide it (Alessi & Battiston, 2022).

2.2.2 The Sustainable Finance Disclosure Regulation (SFDR)

The Sustainable Finance Disclosure Regulation (SFDR) is tailored to draw private investments into activities that facilitate a transition towards a sustainable, climate-neutral economy (European Commission, 2023). It establishes various disclosure obligations based on the categorization of "sustainable investments", which are substantially contributing to environmental or social objectives, provided that such investments are based on good governance practices and do not, at the same time, undermine those objectives.

However, although the SFDR aims to reduce information asymmetries, prevent greenwashing, and direct capital towards sustainable ventures (Bengo et al., 2022, challenges arise from a lack of a clear definition for what constitutes a "substantial contribution" to sustainability, leading to varied interpretations and potential inconsistencies among fund disclosures (Scheitza & Busch, 2023). This ambiguity may allow financial market participants (FMPs) a certain degree of flexibility to develop their own sustainability frameworks for their financial products. Nonetheless, there is an expectation that FMPs must maintain a consistent application of the SFDR's sustainable investment criteria across their product range, ensuring uniformity in their adherence to the regulation's spirit (ESAs, 2022). The SFDR enforces transparency by requiring financial entities to provide clear disclosures about their sustainability practices and the impacts of their products, and this information must be accessible on their websites, in pre-contractual documentation, and through periodic reporting (European Parliament, 2019; Zetzsche et al., 2021). The regulation specifies different levels of disclosure obligations through its articles: Article 6 addresses general disclosure requirements; Article 7 mandates disclosures on principal adverse impacts (PAIs); Article 8 pertains to products promoting social or environmental characteristics; and Article 9 applies to products with sustainability objectives at their core. The latter two articles impose the most stringent disclosure demands, with Article 9 reserved for products that are fundamentally aligned with sustainability objectives.

Article 9 funds. Funds disclosed under Article 9 are expected to create a sustainability-related impact, going beyond ESG performances, which requires that asset managers actively engage with their investee companies and that "highest ESG performances (to) be associated with the generation of positive impacts on ex ante defined overarching sustainability objectives" (Bengo et al., 2022, p. 815).

However, in their comprehensive analysis of 1000 Article 9 funds, Scheitza & Busch (2023) reveal a notable discrepancy: only 60% of these funds can genuinely be considered impact-focused. This finding

underscores the necessity to distinguish between regulatory intent and actual market practices. The SFDR, while aspirational in promoting the highest sustainability objectives, has been met with diverse interpretations by market participants, evidenced by the strategic downgrading of several Article 9 funds to Article 8 in response to regulatory clarifications issued by the European Supervisory Authorities (ESAs) (Furness & Wilkes, 2023). This pattern of adaptation indicates a certain ambiguity within the regulatory framework, yet the underlying goal of Article 9 funds remains steadfastly impact-centric.

While the SFDR does not explicitly define "impact" or provide a concrete definition of sustainability, it sets expectations that funds under Article 9 be fully sustainable. These funds are expected to provide a legitimate reason and methodology for their definitions of sustainability, which they must explain in their required disclosures, such as pre-contractual and periodic reports (Forrester et al., 2021). Furthermore, with the adoption of EU Taxonomy regulation, which complements the SFDR by establishing criteria for determining whether an economic activity is environmentally sustainable, Article 9 funds have an implied responsibility to align their green investments with these criteria. Completely ignored, however, is the extent to which these criteria actually serve as a benchmark for sustainable investments.

2.3 Challenges and Constraints in Impact measurement

Impact measurement presents numerous challenges that complicate the ability of investors and especially asset managers to accurately report on their sustainability outcomes (Le Houérou, 2018). Scholars note that the field is under-institutionalized and suffers from a lack of standardization, with multiple approaches leading to inconsistency and confusion among stakeholders (Höchstädter and Scheck, 2015; Flynn & Barnett, 2017). They have also identified key challenges for more effective impact measurement.

First, there is a notable absence of universally accepted frameworks within impact measurement, leading to varying methodologies and contested definitions (Lehner et al., 2022). The GIIN's Annual Investor Survey illustrates the diverse impact measurement practices, inhibiting comparability and coherence across investments (Hand et al., 2020). (Lack of Alignment on Measurement Approaches). Second, the existing impact measurement tools and methodologies often fail to comprehensively capture impact outcomes. Key resources may require refinement, and many metrics are hindered by limited data availability and verification techniques, as evidenced by the European Commission's identification of these issues (Flynn & Barnett, 2017). (Improving Effectiveness of Measurement Approaches). Then, impact measurement encompasses a variety of methods and tools, often tailored

to individual investments. While some frameworks advocate for rigorous metrics, others emphasize structured investment processes without quantifiable measures (GIIN, 2023; Jackson & Harji, 2012).

2.4 Diverse Approaches to Measurement

Impact measurement lacks a universal approach, yet our study adopts the definition proposed by the Global Impact Investing Network (GIIN). Impact measurement is the practice of "[...] identifying and considering the positive and negative effects one's investment approaches have on people and the planet, and then figuring out ways to mitigate the negative and maximize the positive in alignment with one's goals" (GIIN, n.d.). Historically, investments overlooked environmental and social externalities, focusing primarily on financial returns (Reisman et al., 2018; Schoenmaker, 2017). Today, however, impact measurement has become crucial to ensure investments are generating their intended environmental and social claims (GIIN, 2023; Flynn & Barnett, 2017), thereby providing evidence that invested capital has had an intended effect, enhancing credibility and market differentiation, (Daggers & Nicholls, 2016; Flynn & Barnett, 2017) and attracting more capital the impact investing sector (Social Impact Investment Taskforce, 2014).

A variety of impact measurement tools and approaches exist, tailored to the specific individuality of investments (GIIN, 2023; Jackson & Harji, 2012). The G8's Social Impact Investment Taskforce argues that the objective of impact measurement is to "assess the scope and process for using outcome metrics and to recommend approach and principles for measurement of social outcomes" (Social Impact Investment Taskforce, 2014, p. 1). Mendell and Barbosa (2013) also propose that methods and metrics should be utilized by investors for impact measurement. In contrast, Oleksiak et al. (2015) argue that the deliberate structuring of investments is sufficient and does not include metrics or methods. Alternatively, Findlay and Moran (2019) propose that in the pre-investment phase, a due diligence process and the setting of impact objectives should take place.

Within these tools, however, the Sustainable Development Goals (SDGs) serve as the most common benchmark for setting impact objectives, evaluating impact performance, and reporting on impact performance (Hand et al., 2020). The IRIS Catalog of Metrics and the Core Metrics Set are also widely used, followed by the Impact Management Project (IMP) (Impact Frontiers, n.d.), which core components are enterprise contribution, and impact risk. These diverse approaches to measurement reflect the complexity and nuances or individuality of measuring the impact of investments effectively.

2.5 Opportunities for Advancing Impact Measurement

Despite the complexities and challenges associated with measuring impact, there are significant opportunities for advancement. By exploring empirical insights from experienced fund managers, researchers can enhance understanding of prevailing measurement practices, identify best practices, and propose solutions to existing barriers.

As the impact investing landscape continues to evolve, the interplay between regulatory frameworks, such as the EU Taxonomy and SFDR, and impact measurement practices will significantly shape strategies employed by fund managers. Continued research in this domain is vital for fostering effective impact measurement, aligning with regulatory intent, and ensuring that investments achieve their intended social and environmental outcomes.

To delve deeper into these questions, this paper brings in two studies that examine the strategies employed by impact funds to align with the SFDR, specifically focusing on the practices, challenges, and solutions encountered by impact fund managers and the methodologies used for measuring impact, ultimately contributing to the broader discourse on regulatory influence in the impact investing sector.

3. Regulating Impact Investments? The Influence of the EU Sustainable Finance Framework on Impact Funds

A broad range of sustainable investment approaches have been established. These investments include (in no particular order) sustainability-themed investments, best-in-class investment selection, norms-based screening, exclusion, integration of environmental, social, and governance (ESG) factors in financial analysis, and impact investing. Impact investing, however, emerges as a specialized category within sustainable finance (Busch et al., 2016; CFA Institute et al., 2023).

While EU legislative initiatives have progressed, there is still a research gap regarding their actual effect on impact funds (Barber et al., 2021; Edmans and Kacperczyk, 2022; Kumar et al., 2022). In this first study, we analyse how the funds adapt their impact strategies and structures as the EU Taxonomy and SFDR have entered into force. More specifically, our research focuses on equity impact Article 9 funds under the SFDR and seeks to explore whether the SFDR effectively encourages sustainable investment practices and discourages impact washing among asset managers.

3.1 Research Methods

Data Sample Selection and Collection

As our research objective aimed to explore the influence of the EU Taxonomy and SFDR frameworks on the investment strategies and structures of impact funds, we selected 15 EU-based private equity (PE) firms active in impact investing and experienced in implementing the SFDR framework. Our goal was to conduct semi-structured interviews with managers involved with Article 9 funds on a daily basis focusing the discussion on the effect of the EU Taxonomy and SFDR frameworks on the funds' investment strategy, due diligence, and portfolio companies.

Of the 15 PE firms, five agreed to be interviewed. Four had their headquarters within the EU, and one in the United Kingdom, but with significant operations within the EU geographic sphere. Each firm managed at least one fund categorized as Article 9 under the SFDR. The sampling process involved identifying individuals within these five firms that were engaged with impact investing activities on a daily basis. These individuals were members of an impact division or hold a leadership position, deciding on impact investing initiatives or being responsible for managing ESG funds, sustainability funds, or/and impact divisions. In addition, we aimed at selecting individuals who had expertise in ensuring that their firms adhered to and complied with the EU regulations. The final sample consisted of five PE firms and five participants with diverse responsibilities, including three holding senior positions like directors or heads of impact teams, and two analysts working within an impact team (cf. Table 1). To maintain confidentiality, we omitted specific identifiers, including the names of the PE firms, impact funds, and interviewees.

AuM (USDm)	HQ Location	Employee Count	Investment Objectives	Interviewee Title
4000	Luxembourg	104	Investment in Key Themes: People, Planet, and Productivity	Director of Impact & ESG
1500	United Kingdom	50	Transition to a Sustainable & Inclusive Economy	Impact & ESG Team
1300	Sweden	54	Positive Impact on Society & Planet	Impact Management Director
1300	France	91	Contribute to Responsible & Sustainable Economy	Impact Analyst
n/a	Germany	17	Accelerate Industrial Decarbonization	Head of Impact Management & Measurement

Table 1: Overview of PE firms interviewed

Data Analysis

Data collected through our interviews were transcribed and systematically coded. The process began with the generation of initial codes which were subsequently clustered into broader categories. These categories informed the development of themes that encapsulate the essence of the collected data. Employing the Gioia methodology (Gioia et al., 2013), we further refined these themes into a structured data format (Figure 1). This entailed distilling direct quotations from participants into first-order concepts, which then evolved into second-order themes, and ultimately into aggregate dimensions, which represent overarching concepts (Gioia et al., 2013). As a result, six key impact investing concepts were identified: strategic impact, regulatory evolution, data integrity, impact stewardship, impact integrity, and balancing objectives (Figure 1).

In our qualitative data analysis, we drew on the six dimensions of impact investing Hockerts et al. (2022) have identified to describe impact investing: intentionality, additionality, contribution, materiality, measurability, and attribution—arguing that the presence of some, rather than all, of these dimensions may suffice to classify an investment as impact investing. We then established a link between these specific dimensions of impact investing (Hockerts et al., 2022) and the impact investing concepts we identified in our data analysis. Establishing this relationship constitutes the bedrock of our findings.

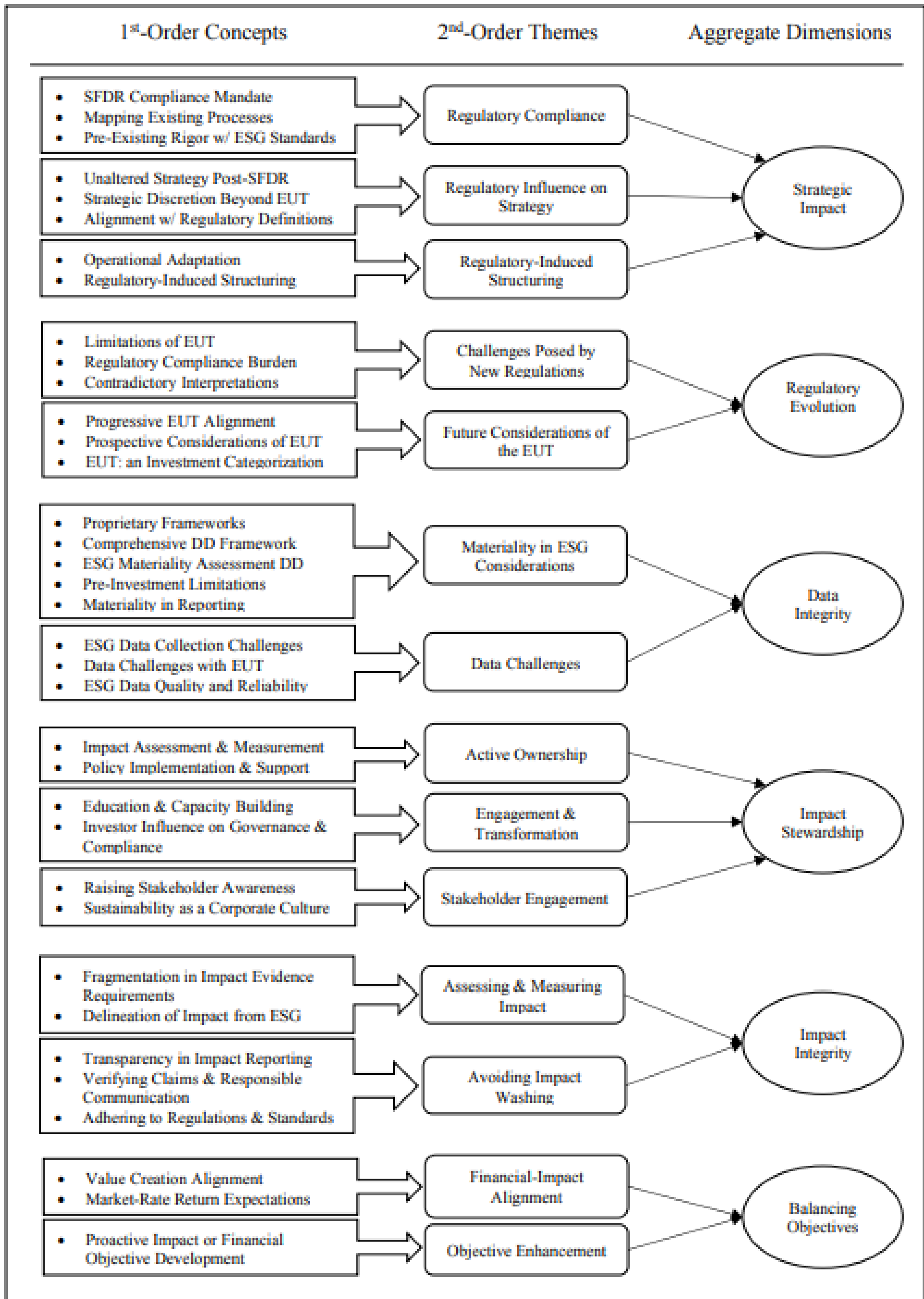

Figure 1: Data Structure

3.2 Findings: Navigating Regulatory Changes

The findings of our analysis offer a nuanced understanding of the impact of the EU Taxonomy and SFDR on Article 9 among impact fund managers. While the strategic influence of these regulations appears limited, their operational and structural implications are significant.

Strategic Impact

The strategic impact of the SFDR and the EU Taxonomy is distilled into three themes: regulatory compliance, influence on investment strategy, and regulatory-induced restructuring. Together, these themes convey that while the regulatory frameworks had a negligible impact on the fundamental investment strategies of funds in general, they necessitated a reconfiguration of structures and processes for compliance purposes.

The research reveals that the EU Taxonomy and SFDR have had a minimal impact on the core investment strategies of impact funds. This stability largely stems from the fact that many funds had already integrated robust ESG and impact-focused elements into their investment processes before the regulations took effect. This finding aligns with previous studies suggesting that firms with pre-existing rigorous sustainability standards are better positioned to comply with new regulations with minimal disruption to their strategies.

Regulatory Evolution

Regulatory evolution encompasses two secondary themes: the challenges of implementing new regulations and the prospective applications of the EU Taxonomy. The former delves into the difficulties of navigating incomplete regulations, the regulatory burdens they impose, and the disparate interpretations they provoke. The latter theme explores the use of the EU Taxonomy as a post-investment analytical tool, its potential integration during the pre-investment phase, and its current function in classifying investments.

Our research shows that, in general, fund managers felt challenged by the recent regulatory evolution. The complexity and breadth of the EU Taxonomy, for instance, mean that its applicability varies across different sectors and activities, leaving some less comprehensively covered. This selective relevance can hinder its immediate strategic utility, leading funds to adopt a more cautious approach towards integrating the Taxonomy into their investment strategies.

The compliance burdens imposed by the SFDR, noted in the interviews, emphasize the significant efforts required to align with new regulatory demands. These include substantial initial investments in adjusting systems, onboarding portfolio companies, and ongoing maintenance of compliance

practices. The high compliance costs and efforts, such as hiring additional compliance staff, reflect the tangible impact of these regulations on fund operations. Adapting to these regulatory changes can be resource-intensive, prompting funds to reassess their internal processes and operational frameworks continuously.

Data Integrity

Under data integrity, two themes emerge: the materiality in ESG considerations and the challenges associated with data. The former addresses the frameworks and processes of due diligence, assessments of materiality, and constraints prior to investment. The latter theme scrutinizes the quality and reliability of data, alongside the obstacles encountered in data collection.

Ensuring data integrity is crucial in maintaining the credibility and effectiveness of impact investing. The study highlights the multifaceted challenges associated with data collection, quality, and reliability. Funds face difficulties in gathering comprehensive ESG data due to varying levels of preparedness among portfolio companies and differences in regional data standards. Smaller companies and those based outside the EU, in particular, struggle with meeting the stringent data requirements of the EU Taxonomy and SFDR.

These challenges underscore the importance of developing robust due diligence frameworks and proprietary ESG methodologies to assess and verify ESG data. The reliance on established frameworks like the SASB materiality map and proprietary assessment tools demonstrates the importance funds place on meticulous and reliable data evaluation. However, the divergence in materiality assessments suggests a need for more standardized and universally accepted impact measurement methodologies to ensure consistency and comparability across the sector.

Impact Stewardship

The data integrity challenges previously discussed underscore the imperative for active and engaged asset ownership to guarantee that portfolio companies possess the requisite processes and capabilities to identify and report their material risks and impacts effectively. Within the realm of impact stewardship, three themes have been delineated: active ownership, which emphasizes the investor's role in influencing company behavior; engagement and transformation, which focus on the collaborative evolution of business practices; and stakeholder engagement, highlighting the importance of interactive dialogue with interested parties.

We find that funds play an instrumental role in guiding portfolio companies towards implementing sustainability practices by identifying policy gaps and working collaboratively to address them. This

active stewardship ensures that companies not only comply with sustainability regulations but also integrate sustainability into their core operations and business models.

The emphasis on educational endeavors and capacity building within portfolio companies highlights the funds' commitment to fostering a deeper understanding of sustainability. Through direct engagement, training, and support, funds help companies enhance their internal processes, ensuring that they are well-equipped to measure and manage their sustainability impacts effectively. This collaborative approach signifies the evolution of impact investors from passive capital providers to active agents of sustainable change.

Impact Integrity

Regarding impact integrity, two themes are prominent: the challenges of impact assessment & measurement (IMM) and strategies to prevent impact washing. These themes address the difficulties stemming from a lack of standardized impact measurement protocols and the vague nature of 'impact' as a concept. Furthermore, they summarize the proactive measures that impact funds employ to avert allegations of impact washing, ensuring that their reported social and environmental effects are genuine and verifiable.

Maintaining impact integrity is paramount in avoiding impact washing and ensuring the authenticity of reported impacts. The research underscores the importance of transparent impact reporting, where funds are committed to being open about their methodologies and any underlying assumptions. This transparency fosters trust and credibility among stakeholders, ensuring that impact claims are not exaggerated or misleading.

Verification of impact claims and responsible communication are critical components of maintaining impact integrity. Funds emphasize the need to accurately attribute impacts, acknowledging their contribution. This disciplined approach to impact communication ensures that reported outcomes are credible and verifiable, reinforcing the sector's integrity.

Balancing Objectives

Balancing objectives within impact funds is delineated along two themes: financial-impact alignment and objective enhancement. These themes explore the interconnectedness of impact and financial outcomes and the ways in which funds bolster their portfolio companies to harmonize financial returns with impact achievements.

The balance between financial performance and sustainability impact remains central to the mission of impact funds. The research indicates that funds aim to achieve market-rate returns while generating positive social and environmental impacts, rejecting the notion of a trade-off between financial and

impact performance. This synergistic relationship underscores the potential for impact investments to align financial success with sustainable outcomes.

The focus on market-rate returns aligns with the belief that impactful companies inherently possess strong growth potential, making them attractive investment opportunities. This perspective challenges the traditional view that impact investments must sacrifice financial returns, highlighting the evolving understanding of the relationship between impact and profitability.

4. Impact Measurement Practices, Challenges, and Solutions Revealed by Impact Fund Managers[3] in Germany and Switzerland

Measuring the impact of investment practices remains one of the most significant challenges for asset owners and asset managers in the realm of impact investing. Despite the growing interest in sustainable finance and the increasing number of sustainable and impact investment products available, many fund managers grapple with a lack of standardization in impact measurement frameworks, tools, and principles. This ambiguity creates a 'black box' effect, making it difficult for investors to evaluate the true impact of their investments. Fund managers face various challenges, including conflicting stakeholder interests, the mislabeling of impact products, and inconsistent metrics, all of which hinder effective assessment and reduce transparency in the sector.

We intend to open this 'black box' and explore this complex landscape by providing empirical insights from fund managers who are daily active in the impact investing field, examining how they currently navigate impact measurement, and identifying common frameworks and tools. We ultimately intend to shed light on the strategies they use to make their impact measurement practices more effective.

4.1 Research Methods

To understand how fund managers (FMs) measure the impact of their impact investments, we conducted nine semi-structured interviews with nine individuals[4] involved on a daily basis in impact

[3] In this section of the paper, fund managers (FMs) refer to organizations managing money on behalf of another individual or group through impact investments (and not to specific individuals).

[4] Of the 41 individuals contacted in 22 FMs, nine accepted to be interviewed. Four came from FMs active in private equity, six in private debt, one in public equity, and one in public debt. Some FMs offer more than one asset class to their clients. Regarding size, two of the fund managers are considered small with less than USD 100m AUM; two fund managers are considered medium with USD 100 to 500m AUM; three are considered

measurement at FMs that are active in private debt, private equity, public equity, and public debt, and which are headquartered in Germany and Switzerland (Table 2). These two countries are both economic powerhouses within Europe. In 2022, Germany had Europe's largest economy in terms of GDP at EUR 3.9 trillion and Switzerland ranked eighth with an economy of EUR 0.8 trillion (McEvoy, 2023). Second, in comparison to other European countries, Germany and Switzerland are highly active in the impact investing space: according to the *Impact Database* website, Switzerland has the second highest number of FMs in Europe (14), followed by the Netherlands (13) and then Germany (10) (Impact Database, n.d.). Third, the financial cities within Germany and Switzerland—Frankfurt and Zürich, respectively—are major international financial hubs: according to the Global Financial Centres Index (GFCI), (Z/Yen Partners, 2022). On a European level, Frankfurt ranks third and Zürich ranks seventh (ibid). As a result, Switzerland and Germany present an interesting case study in impact measurement due to their strong presence in the global financial sector and facilitation of impact investments.

Size	AUM (USDm)	Company HQ
Small	30	Switzerland
Small	50	Germany
Medium	180	Switzerland
Medium	200	Germany
Large	2000	Germany
Large	7500	Switzerland
Large	9800	Switzerland
n/a	*Unavailable*	Germany
n/a	*Unavailable*	Germany

Table 2: Overview of the Fund Managers' Size and Geographies

The interview questions prompted the interviewees to elaborate on specific frameworks, tools, principles, and/or scores. In addition, some interviewees were asked questions regarding motivators for measuring impact, the change the fund manager is seeking, usage of investment criteria such as intentionality, measurability and additionality, length and frequency of impact measurement, and

large with over USD 500m AUM (ibid). Two fund managers did not publicly disclose their AUM so this information was excluded. Four of the interviewees are headquartered in Switzerland and five in Germany.

thresholds and targets for portfolio companies. Following the impact measurement practices question, the interviewees were asked to share the biggest challenges they face while measuring the impact of their impact investments. During the interviews, the researcher focused on grouping these challenges into internal and external categories relating to whether or not the challenges stem from inside or outside the organization. After revealing impact measurement challenges, the interviewees were then asked to discuss possible solutions to overcome barriers and improve the effectiveness of impact measurement.

Data Analysis

Data from the interviews was analyzed using an inductive, open coding scheme in which themes emerged from the raw data. The first step in the data analysis process was to read the data in the form of transcripts (Tesch, 2013). Certain phrases that represent insightful thoughts relevant to the research question were highlighted (Miles & Huberman, 1994). Following Hsieh and Shannon's (2005) QCA approach, these significant quotes were then converted into initial codes. The initial codes were then organized into categories, which were then sorted into meaningful clusters based on impact measurement practices, challenges, and solutions (ibid). Ultimately, the clusters are the main findings of this paper where both terms are used interchangeably.

4.2 Results: Advancing Impact Measurement

We identify three prevalent impact measurement practices and two main impact measurement challenges, and propose options to overcome internal and external barriers.

Status Quo Analysis of Impact Measurement Practices

Fund managers utilize internal, external, and/or hybrid systems to measure the impact of their impact investments (Findings 1, 2, and 3). The fund managers utilize internal impact measurement systems. It was mentioned by all 9 interviewees (with a total of 86 supporting quotes). Table 3 shows the four categories on which finding (1) is based and the number of interviewees who contributed to each (in parenthesis). Six of the interviewees utilize internal due diligence processes, eight utilize internal impact indicators, seven utilize internal methodologies, and eight utilize internal impact targets and objectives. Internal impact measurement systems relate to the systems that are developed inside the organization (the fund manager).

Finding (1): Utilization of internal impact measurement systems			
Utilization of internal due diligence processes (6)	Utilization of internal impact indicators (8)	Utilization of internal impact methodologies (7)	Utilization of internal impact targets and objectives (8)

Table 3: Utilization of Internal Impact Measurement Systems

Utilization of External Impact Measurement Systems

The fund managers also utilize of external impact measurement systems, but to a lesser extent. It was mentioned by 8 of 9 interviewees with a total of 31 supporting quotes. Table 4 shows the four categories which finding (2) is based on and the number of interviewees who contributed to each category. Three of the interviewees utilize external impact indicators, five utilize external impact methodologies, three utilize external impact principles, and six utilize external impact targets and objectives. External impact measurement systems relate to the systems that originate outside of the organization.

Finding (2): Utilization of external impact measurement systems			
Utilization of external impact indicators (3)	Utilization of external impact methodologies (5)	Utilization of external impact principles (3)	Utilization of external impact targets and objectives (6)

Table 4: Utilization of External Impact Measurement Systems

Utilization of Hybrid Impact Measurement Systems

Hybrid impact measurement systems are also used, again to a lesser extent than internal ones. It was mentioned by 6 of 9 interviewees with a total of 9 supporting quotes. Table 5 shows the two categories on which finding (3) is based and the number of interviewees who contributed to each category. Two of the interviewees utilize internal systems which are inspired by external systems and six utilize internal systems which contain external elements.

Finding (3): Utilization of hybrid impact measurement systems	
Utilization of internal systems inspired by external systems (2)	Utilization of internal systems containing external elements (6)

Table 5: Utilization of Hybrid Impact Measurement Systems

Impact Measurement Challenges

Our findings (4) and (5) presented in table 6 and 7 cover the impact measurement challenges impact fund managers face, shedding light more specifically on the internal and external barriers to impact measurement.

We identified three internal barriers inhibiting the effective impact measurement. This was mentioned by 8 of 9 interviewees with a total of 19 supporting quotes. Table 6 shows the three categories on which finding (4) is based and the number of interviewees who contributed to each category. Six of the interviewees recognize the barrier of impact evaluation complexity, four that of internal capabilities, and five that relating to internal resources.

Finding (4): Internal barriers inhibiting effective impact measurement		
Impact evaluation complexity barrier (6)	Internal capabilities barrier (4)	Internal resources barrier (5)

Table 6: Internal barriers inhibiting effective impact measurement

We identified four external barriers inhibiting effective impact measurement. This was mentioned by all 9 interviewees with a total of 60 supporting quotes. Table 7 shows the four categories on which finding (5) is based and the number of interviewees who contributed to each category. All nine of the interviewees recognize the barrier posed by conflicting approaches and priorities, eight that of data collection, three that of external measurement systems, and four that of regulation.

Finding (5): External barriers inhibiting effective impact measurement			
Conflicting approaches and priorities barrier (9)	Data collection barrier (8)	External measurement system barrier (3)	Regulation barrier (4)

Table 7: External barriers inhibiting effective impact measurement

Proposals to Overcome Internal Barriers

Five of nine interviewees offered proposals to overcome internal barriers (a total of 9 supporting quotes). Table 8 shows the two categories which finding (6) is based on and the number of interviewees who contributed to each category. Two of the interviewees support regular and verified impact reporting and three support setting targets and indicators.

Finding (6): Proposals to overcome internal barriers	
Regular and verified impact reporting (2)	Setting targets and indicators (3)

Table 8: Proposals to Overcome Internal Barriers

Proposals to Overcome External Barriers

Four proposals to overcome external barriers were mentioned by 8 of 9 interviewees with a total of 25 supporting quotes (Finding 7). Table 9 shows the four categories of proposals and the number of interviewees who contributed each. Four of the interviewees propose education on impact topics, three propose increased collaboration with stakeholders, five propose industry standardization and alignment, and six propose mandatory regulations.

Finding (7): Proposals to overcome external barriers			
Education on impact topics (4)	Increased stakeholder collaboration (3)	Industry standardization and alignment (5)	Mandatory regulations (6)

Table 9: Proposals to Overcome External Barriers

Interconnectedness

Our research findings indicate that there is a level of interconnectedness between the internal and external challenges and the internal and external solutions. Although the nine interviewees were not specifically asked to connect their proposals with the barriers, most did so. Figure 2 visually depicts these connections. Specifically, this figure proposes how the four external barriers revealed by interviewees are connected to four external solutions; additionally, three internal barriers are connected to two internal solutions.

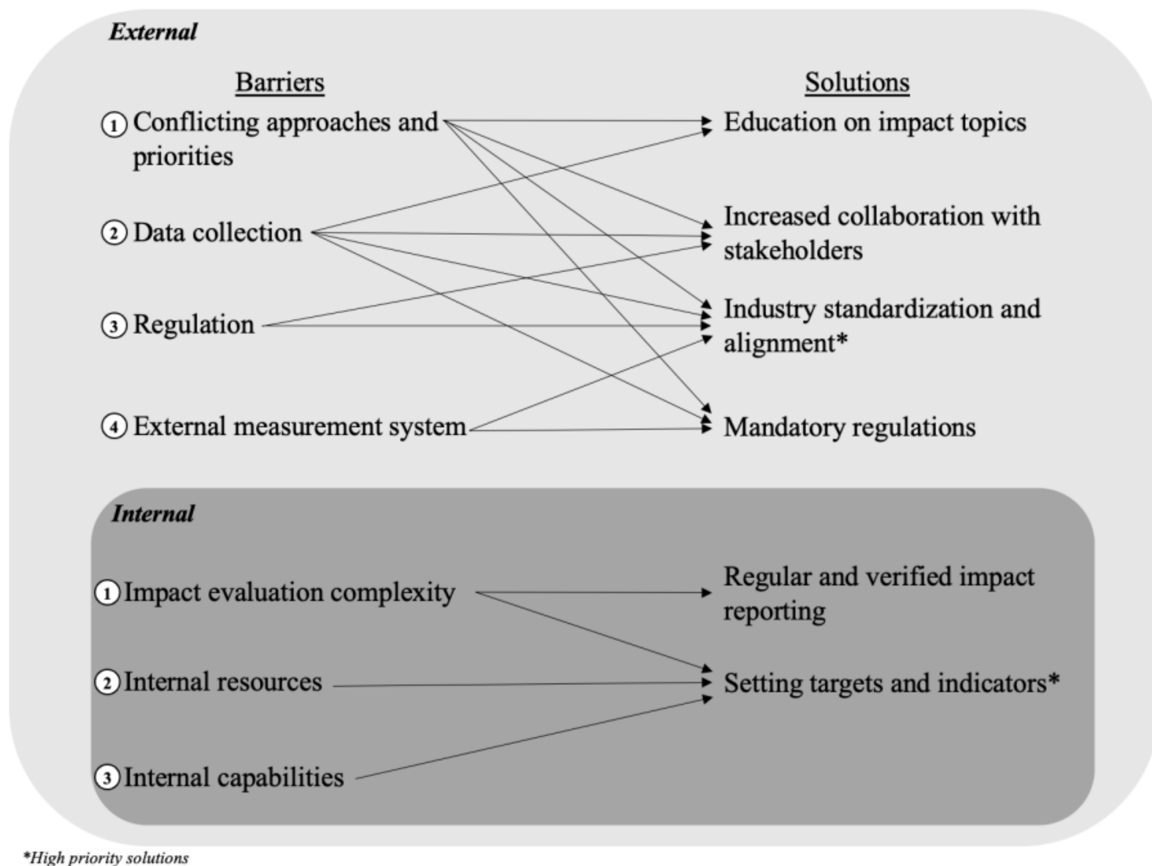

Figure 2: Interconnectedness of Challenges and Solutions

Our analysis reveals a catalog of practical fund manager-led solutions addressing specifically barriers to impact measurement practices. Our findings indicate that fund managers adopt various internal, external, and hybrid measurement practices due to misalignment within sustainable finance regulatory frameworks. Major barriers include conflicting stakeholder approaches and priorities, data collection issues, lack of aligned metrics, product and mislabeling, and insufficient third-party verification. Proposed solutions include education, setting clear targets, enhancing collaboration, and implementing mandatory regulations. measure the impact of their impact investment products and how they expect regulation to enhance impact investing practices.

The research highlights that while fund managers work diligently to improve and align their impact measurement practices, notably with the SFDR and the EU Taxonomy, resolving conflicting approaches remains a top priority. Therefore, addressing both internal and external challenges, such as mislabeling and a lack of consensus on metrics, is essential. As impact measurement practices continue to evolve, ongoing research and open discussions are essential to address conflicting methods.

5. Policy Implications

Governments have the ability to "create a policy environment that fosters the growth of impact investing" (Jackson & Harji, 2012, p. 34). However, the current European Sustainable Finance Regulatory Framework presents a complex landscape of both opportunities and challenges for impact funds.

Our research identifies several significant challenges within the existing regulatory framework. Foremost among these is the perceived complexity of current regulations, which fund managers often find confusing and potentially obstructive to impact investing. This complexity is compounded by widespread concerns about the efficacy of existing regulations in mitigating greenwashing.

The research underscores the critical need for policymakers and regulators to support the impact investing market through policies and regulations encouraging effective and standardized impact measurement approaches to ensure the growth of this sector. The lack of standardization, which impedes comparability and consistency across the sector, presents regulators with the challenging task of crafting policies that encourage impact measurement alignment while remaining responsive to the diverse needs of fund managers in the European sphere. Furthermore, the research highlights a fundamental debate between proponents of a decentralized, market-led regulatory approach and those advocating for more stringent, mandatory regulations.

In response to the challenges presented by the current European Sustainable Finance Regulatory Framework, fund managers recognise its potential for improvement. There is a consensus on the critical need for greater standardization, including harmonisation of impact measurement practices. Drawing from previous research and the findings of our both studies, our paper emphasizes the need for regulators to be attentive and responsive to fund managers' needs when developing policies that encourage impact measurement approaches aligned with EU regulations. To enhance the impact investing market and the effectiveness of impact measurement, policymakers should consider the seven following key recommendations:

1. Reduce the complexity of the SF regulatory framework for optimal adherence of impact fund managers, and provide clearer guidelines on data collection for transparent reporting.
2. Develop a more nuanced product classification system for sustainability-related investments, moving beyond the current three-level contribution model (neutral contribution, harm mitigation, positive contribution), and introducing more granular thresholds to better reflect the diverse range of impact investments, notably an explicit recognition of investor contribution (required for active impact generation).

3. Harmonize the interpretations of Article 9 funds across EU member states to ensure consistent application of regulations by providing additional guidance.
4. Ensure that regulatory frameworks align with the strategic considerations of impact funds, balancing regulatory demands with impact objectives and investor expectations.
5. Develop standardized approaches for defining and prioritizing materiality in impact assessments across asset classes, including guidance on balancing financial and impact materiality.
6. Incentivize fund managers to invest in transitioning brown assets, i.e. in assets that have a clearly defined and measurable transition plan to become greener.
7. Encourage the development and adoption of standardized impact measurement methodologies, including support for the collection and verification of relevant metrics to improve comparability and reliability of impact assessments, therefore facilitating transparent reporting of impact data, and discouraging impact washing among asset managers.

By implementing these recommendations, policymakers can create a more conducive environment for compliance with the Sustainable Finance Regulatory Framework, impact investing and effective impact measurement, ultimately contributing to the sustainable transition of the economy.

CONCLUSION

Despite various regulatory efforts, it appears that the contribution of investors has not yet been adequately reflected upon in all existing regulatory frameworks, indicating a critical area for improvement. Addressing this gap is essential to allow for a better alignment between regulatory measures and the objectives of impact investing. This paper underscores the importance of refining these aspects to ensure a wider and more effective adoption and implementation of the sustainable finance regulatory landscape.

The potential of impact investing to mobilize private capital towards sustainable economic activities aligns best with the overarching goal of the European Green Deal, the EU Taxonomy and the Sustainable Finance Disclosure Regulation, which aim is to foster positive changes towards a more sustainable and equitable global economy. However, amidst the growth of impact funds and the even bigger potential surge in global assets under management in this sector, concerns regarding impact washing have emerged. Without clearer but also simpler guidelines as regards how to classify impact

investment products within the larger sustainable investment field, the risk of misleading claims and confusion in the market will be exacerbated.

The two sets of findings presented in this paper shed light on the impact of regulatory frameworks on impact funds which are categorized under SFDR Article 9 and emphasize the importance of transparent reporting, data integrity, and accurate impact investment measurement practices. By exploring how impact fund managers navigate compliance with regulatory demands and balance impact objectives, policymakers can gain valuable insights into enhancing the effectiveness of regulatory frameworks and promoting alignment with sustainability goals.

Moving forward, policymakers should consider refining regulatory frameworks to address practical challenges faced by impact funds, promote greater clarity and consistency in classification, and encourage standardized impact measurement methodologies. The need for more clarity and consistency in the European regulatory initiatives on what constitutes an impact investment product is essential if the European authorities seek full transparency in sustainability considerations of financial products from investors and an effective implementation of the regulations.

In conclusion, as impact investing can play a pivotal role in driving sustainable economic growth, policymakers must remain attentive to the evolving needs of the market and strive to create an enabling regulatory environment that fosters transparency, accountability, and innovation in impact measurement practices. By doing so, we can pave the way for a more sustainable and responsible investment landscape that contributes to positive social and environmental outcomes.

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