

# Morgan Lewis

## IMPACT INVESTING DESKBOOK SERIES

### Incentivizing Impact: Linking Fund Manager Compensation to Impact Performance

For most private investment funds, managers are compensated through two mechanisms: an annual management fee and performance-based carried interest, or “carry.” The management fee, typically a fixed percentage of committed or invested capital, is intended to cover operating costs and provide stable compensation regardless of performance. Carry, on the other hand, acts as the incentive mechanism. Carry generally entitles the manager to a percentage of the fund’s profits after investors have received their capital back and, in many cases, a pre-determined return on that capital termed a preferred return. This distribution structure, termed a “waterfall,” means that managers are rewarded only once investors achieve targeted financial outcomes.

Where profit maximization is the primary goal, this incentive structure makes sense and has proven very effective. If the manager generates more profits for investors, it earns a greater share of those profits. However, in the impact fund context, where a fund sets out to achieve both financial returns and social or environmental outcomes, compensating managers solely based on financial performance fails to capture the full set of objectives that investors care about. This gives rise to the simple (at least in theory) concept of impact-linked compensation, an approach that ties some portion of a fund manager’s compensation to the achievement of predefined social or environmental metrics.

Given the immense variety of social and environmental impact goals that a fund may pursue, and the imperfect methods for measuring such goals, there is no clear market standard on how to link compensation to impact. Without a standard, there is a high barrier to adoption due to development costs, the operational burdens, and general resistance to change. At the same time, the absence of a market standard creates room for experimentation and innovation.

One of the most in-depth resources on this topic, a 2024 study entitled “Impact-Linked Compensation: Considerations, Design Options and Frameworks,” produced by Tipping Point Fund on Impact Investing and The ImPact, identifies all the moving parts and competing elements in producing an appropriate impact-linked compensation scheme and organizes them into an overall framework.<sup>1</sup> The goal of this article is to acknowledge both the desire and the logic for accountability that impact-linked compensation promises, and the challenges involved when trying to implement it.

***Choosing Impact Goals and Metrics:*** Before a fund can tie a manager’s compensation to “impact,” the investors and the fund manager have to agree on what “impact” actually means and how it will be

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<sup>1</sup> <https://impactlinked.co/>

measured. Different investors may care about different kinds of impact, even within the same sector, and investors may measure success differently, even if they share the same overall mission. For instance, one investor in an affordable housing fund may care about how many low-income families are helped, while another may care about how many housing units get built. Designing impact-linked carry starts with aligning investors and the GP on which impact objectives and metrics will determine compensation.

***Setting Targets:*** Once impact goals are agreed on, appropriate targets are needed. If the goal is carbon capture, how much carbon needs to be avoided/sequestered to provide meaningful impact, without being too much to be out of reach or too little to be too easily achieved? Can the targets be adjusted and by whom? Are the outcomes calculated at the fund level or the portfolio company level? If at the portfolio company level, who will set the impact targets and metrics for each company? Is it the manager, the investors, an impact advisory committee, or a neutral third party?

In practice, one approach funds have taken is to set impact targets in collaboration with portfolio companies that are then approved by an investment advisory committee. Other funds rely on a target-setting methodology with investors at the outset, with oversight by investors conducted through reporting rather than formal approval of each target.

***Ensuring the Metrics Reflect True Impact:*** Selecting suboptimal metrics for impact risks skewing fund manager incentives toward investments that do not reflect on-the-ground impact or, worse, ones that run counter to the impact goals and values of the fund. Additionally, the metrics need to align with the manager's theory of change and should be integrated throughout the manager's investment and reporting process. Will the fund take on a third-party advisor or a third-party standard or involve those impacted by the fund's investments in the selection of metrics? And once metrics are set, will the fund documents permit the fund manager to make changes at their discretion?

## **Measuring Impact**

***Assessing and Monitoring Performance:*** Given the subjectivity that may be involved in impact measurement, processes need to be implemented to standardize performance measurement. For fund managers, the more subjective the target measurement, the greater the appearance of a conflict of interest in compensation linked to performance outcomes determined by the fund manager. Who will decide whether the manager has met the impact targets? Is it up to the board, the manager, or an investor advisory committee? Will an external impact advisor be used to verify data and, if so, at which points in the process?

***Timing of Measurement:*** The timing of when impact becomes measurable may not align with GP compensation timelines. Typically, carry is paid to fund managers upon disposition of portfolio companies, but the impact of an investment may take longer to materialize, creating a gap between financial returns and measurable impact. When should impact be measured—at the beginning of the fund, at the end, or through ongoing assessments? Is there a risk that the manager is overcompensated if a fund ultimately falls short of meeting its impact targets? And how will investors get this money back?

In practice, managers use a range of approaches to reduce subjectivity and strengthen oversight. Some rely on third-party standards and composite scorecards to anchor measurement in established frameworks. Others involve stakeholder advisory bodies or community representatives in selecting

metrics and validating performance. Some combine external data collection and evidence-based methodologies with beneficiary feedback to inform assessments. Where direct measurement is difficult, managers may use proxies supported by internal methodologies or industry-aligned indicators, often reviewed by independent experts or committees to enhance credibility and mitigate conflicts of interest.

## **Linking Impact to Compensation**

The following is a list of issues to consider in designing a framework for impact-linked compensation.

***Carrot vs. Stick:*** The “carrot” approach to impact-linked compensation involves setting a base rate of compensation for achieving specified impact targets. Alternatively, a certain level of carried interest may be tied to financial performance with an additional percentage being unlocked when impact targets are met. We can look to executive ESG incentives for an example whereby CEO pay is partially tied to achievement of ESG metrics. Conversely, with the “stick” approach, a fund might start with a baseline carried interest, with a percentage being forfeited if the impact targets are not met. Other managers adopt a sliding-scale approach, where compensation increases progressively with impact performance. For instance, no carry may be paid below a minimum threshold (e.g., 25% of the target), with incremental increases as impact improves, and full carry only unlocked once the target is achieved.

***Reduction of the Preferred Return as a Management Incentive:*** One creative approach for incentivizing the GP to hit impact targets is by lowering the preferred return received by LPs when certain targets are met. This benefits the GP, who, as a result, receives their portion of the carry sooner, with minimal impact on the proportion of the profits distributed to the LPs.

***Management Fee Tied to Impact Approach:*** Although carry is the standard for aligning incentives between GPs and LPs, other attempts to tie impact performance to GP remuneration include tinkering with the management fee by tying a portion of the fee to impact metrics.

***Complexity of Structuring Carried Interest:*** Carried interest arrangements are inherently complex and interconnected with other provisions throughout any legal agreement. Introducing provisions that account for impact performance will necessitate modifications to legal agreements that require careful negotiation in a potentially costly process. How can fund managers balance the need for bespoke legal arrangements with the goal of managing costs?

***Accounting and Tax Implications:*** The governing agreements for investment funds require profits and losses to be allocated annually among the investors for tax purposes, even if no distributions are made. When carried interest is allocated pending the achievement of impact targets, it becomes difficult to accurately allocate these profits between the investor and the fund manager. How will the retention of carried interest pending the determination of whether the investor has achieved impact targets affect the allocation of profits for tax purposes?

***Allocating the Cost of Impact Measurement:*** As impact measurement is often bespoke, the impact-linked compensation process can be resource intensive, involving expenses related to impact experts, data collection, impact management systems, and sharing results with stakeholders. Will costs be allocated as a fund expense under the LP agreement, or covered by the management fee? In practice,

many managers cover the costs of impact measurement and governance through management fees while some funds have opted to employ the support of technical assistance facilities.

***Negotiation Dynamics:*** LPs can vary in whether they are impact-first, and thus willing to trade financial returns for additional impact. Managers may be reluctant to depart from traditional modes of compensation. Whether the desire for impact-linked compensation comes from the LP, the sponsor or the manager will affect negotiation dynamics.

As illustrated briefly here, structuring impact-linked compensation adds layers of complexity to the fund manager compensation structure. Successfully navigating these complexities demands a thoughtful balancing of various considerations and should be approached with care. The best and most fruitful approach is to embrace the conversation and be clear-eyed about the challenges.

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For more information on the issues discussed here, please contact your Morgan Lewis [Impact Investing](#) attorney.

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