Principles for Responsible Investment

TECHNICAL GUIDE FOR LIMITED PARTNERS: RESPONSIBLE INVESTMENT IN PRIVATE EQUITY

FINANCE UNEP INITIATIVE

United Nations Global Compact

An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

THE SIX PRINCIPLES

PREAMBLE TO THE PRINCIPLES

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

1 We will incorporate ESG issues into investment analysis and decision-making processes.

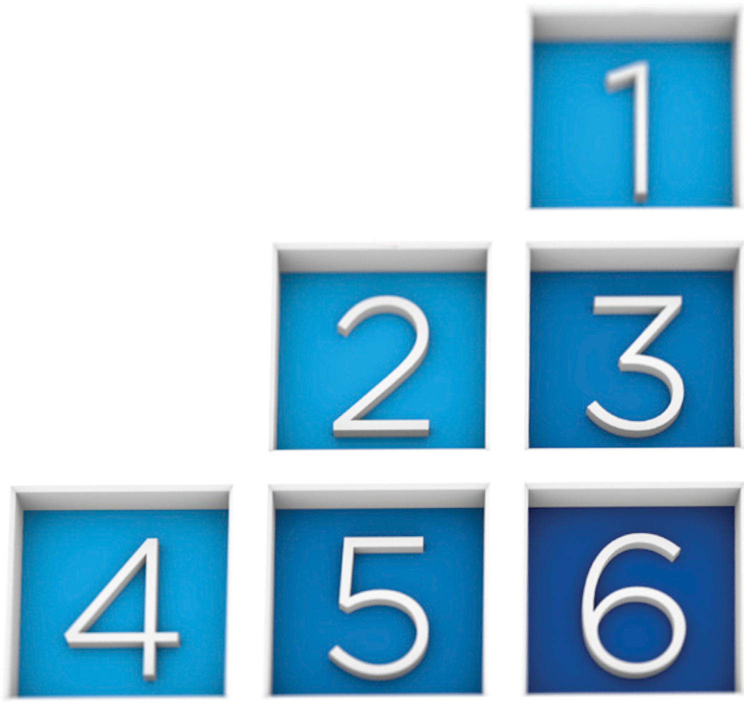
2 We will be active owners and incorporate ESG issues into our ownership policies and practices.

3 We will seek appropriate disclosure on ESG issues by the entities in which we invest.

4 We will promote acceptance and implementation of the Principles within the investment industry.

5 We will work together to enhance our effectiveness in implementing the Principles.

6 We will each report on our activities and progress towards implementing the Principles.



PRI's MISSION

We believe that an economically efficient, sustainable global financial system is a necessity for long-term value creation. Such a system will reward long-term, responsible investment and benefit the environment and society as a whole.

The PRI will work to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

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EXECUTIVE SUMMARY

The appetite for ESG integration in private equity has grown strongly since the 2nd edition of this guide in 2011. Limited Partners (LPs) and General Partners (GPs) realise that responsible investment can contribute to both value creation and risk mitigation in this asset class. However, given the relationship between the LPs, GPs and portfolio companies, there are certain challenges to implementing responsible investment in private equity.

This guide is for any LP seeking to develop its own approach to responsible investment with respect to its private equity investment strategy, including (but not limited to): venture capital, growth capital, mid-market, buy-out, mezzanine, co-investments, secondary investments, distressed and special situations and funds of funds. It may also provide assistance to investors in other private market strategies if they use a private equity-style closed-ended fund structure, such as infrastructure and real estate.

This guide is not intended as a checklist, nor does it advocate altering a GP's management role and discretion over decision-making. Some aspects may seem aspirational for some private equity participants. It aims to present insights and provide actionable ideas into how responsible investment can be implemented by a broad range of LPs and GPs.

WHY INTEGRATE ESG FACTORS INTO PRIVATE EQUITY INVESTMENTS?

In private equity, responsible investment is the practice of incorporating environmental, social and governance (ESG) factors into investment decisions and active ownership during the due diligence process, the investment holding period and upon exit. This process can create value and act as an important risk mitigator. Due to the arms length nature of the LP relationship with the portfolio company and the illiquid nature of assets, it is key that the LP has assurance that the GP is identifying and managing future ESG risks and opportunities. A focus on processes and practices helps to deliver that assurance.

Misconceptions about responsible investment remain. There is no one right way to practice responsible investment and this guide presents various considerations and options for LPs that might be tailored to their own investment approaches, beliefs and strategies. For investors just embarking on this journey, there are a few things they can do to build capacity within their organisation, including learning from others and leveraging existing industry knowledge and experience.

THE CURRENT ESG LANDSCAPE IN PRIVATE EQUITY

The evolution of responsible investment in private equity has been driven by developments including new regulatory and legal guidance and the rise of issues such as board diversity and climate change. The level of uptake of responsible investment throughout the investment sector means that this approach is now widely discussed and broadly accepted.

Despite these developments, there are challenges to this process including: misconceptions around fiduciary duties and responsible investment, establishing a clear mandate to provide guidance to investment teams, a wide dispersion of ESG knowledge within both LPs and intermediaries and establishing a common dialogue and taxonomy across the industry.

As well as highlighting some of the current regulatory and legal developments, such as the EU's sustainable finance taxonomy to improve disclosure, the guide seeks to dispel some of the more common myths associated with LPs wishing to introduce a greater level of engagement with GPs on responsible investing.

For those embarking on this journey for the first time, the guide details five steps, and associated objectives to build capacity and to leverage existing knowledge and processes.

TOOLS AND TECHNIQUES FOR ESG INTEGRATION IN PRIVATE EQUITY

This guide covers the private equity investment process starting from the fundamental underpinnings of investment policies and beliefs, through to the exit phase. It draws on PRI guidance on diligence, fund terms and monitoring as well as industry best practices and existing collaborative frameworks to summarise recommendations at each stage of the investment process.

Private equity - unpri.org

An introduction to responsible investment in private equity

2018 private equity snapshot report

We hope you find the guide useful and welcome feedback.

The document is divided into four sections:

SECTION 1:

An overview, which describes how the Principles of Responsible Investing apply to private equity and explores the intersection of key characteristics of private equity and ESG.

SECTION 2:

A review of how the private equity landscape has changed since the 2nd edition of this guide (2011) and implications.

SECTION 3:

Substantive guidance for how an LP might integrate ESG considerations into the private equity investment process, including:

- Policies and goals for any LP, regardless of the maturity of their responsible investment plans
- Investment policy and decisions
- Ownership activities, i.e. monitoring, engagement and disclosures

APPENDICES:

Additional resources for implementing an ESG policy, including suggested due diligence and engagement questions, information on ESG terms in existing side letters, guidance on the scope of ESG, and a list of some key ESG codes and standards.

For any questions or feedback, please contact privateequity@unpri.org.

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FOREWORD

Alongside the growth of passive strategies and ESG, the growth of private equity as an asset class has been a key theme in capital markets over the last decade. Capital has increasingly turned away from public markets – especially from institutional asset owners. Capital allocated to private equity has grown from rapidly over the last ten years.

This poses new challenges and opportunities for LPs and GPs. Private equity faces the same systemic challenges around climate risk, human capital, resource shortages as equity investors but through a different regulatory lens. Ultimately, each market also has the same clients.

Yet responsible investment has historically developed in the equity markets. Asset classes 'in the shadows' have avoided some of the regulation associated with governance practices or reporting. But in the eyes of politicians, asset owners and regulators, this is changing and changing rapidly. In the US, UK and elsewhere, politicians increasingly see private equity as a target for 'mud slinging'.

Asset owners are realising that efforts they put into reviewing equity portfolios should be reflected across all asset classes and regulators see market risk in new areas and asset classes. Regulations such as the California's Transparency in Supply Chains Act and the UK's Modern Slavery Act do not differentiate between the mechanism of ownership. The relationship between GPs and portfolio companies also puts them in a privileged position in terms of prioritising these types of issues – making a real positive impact in the environments these businesses operate.

If these were push factors for more actively incorporating ESG into PE practices, then the pull factors remain consistent with other asset classes. Investment opportunities driven by the energy transition or resource efficiency plus the increasing evidence around correlation between returns and better ESG management are all independent of ownership mechanisms. GPs who are not investigating different ways to allocate capital are likely to get left behind.

For a range of reasons – some similar, some new, some changing – private equity GP and LPs will have to stand up and be counted on meeting a range of global and local challenges. As a minimum, participants need to adhere to the highest ethical and professional standards, deal fairly and honestly, act with integrity and transparency and invest responsibly.

Fiona Reynolds
Chief Executive Officer, PRI

The environment for investors across asset classes is changing. Drivers are not going away and market participants who ignore them are likely to face backlashes from clients, regulators and politicians. Business as usual is no longer acceptable.

We hope that this guide provides a little help in developing the market for more responsible participants in the private equity space.

FOREWORD

Much has changed across the responsible investment landscape since the 2nd edition of the LP guidance was published in 2011. The value proposition for ESG integration in private equity is stronger than ever and so too is the need for clear thinking and decisive action. We are long past the time to “wait and see” if ESG integration is a worthwhile undertaking for investors. Any LPs or GPs who are not thinking about relevant ESG factors are shirking their fiduciary duty and putting their portfolios at greater risk.

This guidance is not intended to provide the final word on responsible investment in private equity. It aims to help those LPs—and curious GPs—beginning their journey in responsible investment or private equity, and give fresh perspective to those that have started down the path and are looking for ways to improve. It provides a framework through which we view ESG integration and a baseline of important concepts. Each section presents a series of jumping-off points for further exploration and consideration, with references and links to specific tools dealing with more advanced concepts.

When I first got involved in responsible investing, I read every PRI reference guide I could get my hands on. I still have the dog-eared copy of the 2nd edition of the LP guidance—as well as the GP Guide, the Private Equity DDQ, and a handful of other PRI responsible investment reference guides—on my desk. I hope this 3rd edition provides a similarly comprehensive introduction for practitioners coming to these topics today.

If there were a single, clear formula for practicing responsible investment in private equity, we would have provided it here. Alas, there is no one-size-fits-all solution. Every LP and GP needs to consider how these factors and considerations affect their investment activities and practices. For those readers who are already well along in their journeys, we hope this guidance reinforces their beliefs and goals. For those new to responsible investment or to private equity, we hope this guidance provides a useful reference that you continue to turn to for years to come.

Michael Cappucci
Managing Director, Compliance and Sustainable Investing, Harvard Management Company Inc & Private Equity Advisory Committee Chair

SECTION 1:
RESPONSIBLE INVESTMENT AND PRIVATE EQUITY

This section outlines the key drivers of ESG integration in private equity: value creation and risk mitigation and covers areas including:

- How different private equity ‘processes’ impact the integration
- Links to a discussion on fiduciary duty and ESG
- The PRI Principles in private equity
- A table of myths and facts about responsible investment
- Five capacity building actions for investors new to managing ESG

The PRI defines responsible investment as a strategy and practice to incorporate environmental, social and governance (ESG) factors in investment decisions and active ownership[1]. In the private equity market, Limited Partners (LPs) - who are stewards of capital - have a fiduciary duty to ensure that committed capital is managed appropriately and in line with their interests & policies. To that end, responsible investment is a systematic approach to evaluate and integrate material ESG risks, opportunities and issues into asset selection & ownership and portfolio construction.

For investors, including LPs and General Partnes (GPs), the focus is increasingly not “if” they should integrate ESG but “where, how, and is it feasible?” and key drivers include value creation and risk mitigation.

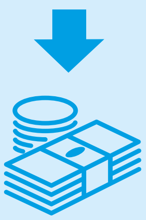
VALUE CREATION

The opportunity for private equity can be expressed as the difference between the cost of sound ESG management and its resulting impact on costs, profitability, revenue and the balance sheet. Measures might include EBITDA during the holding period, exit multiples and the ease of exit.

For example, steps to address ESG that can benefit the bottom line include:

- Improved ESG performance can create operating efficiencies that translate into cost savings and improved financial performance
- Energy efficiency or employee / workplace plans can have a positive financial impact, with a short payback period that can be measured from the financial accounts
- Development of new products and improved innovation
- Compliance with environmental / social law reduce possibility of fines and penalties.

Figure 1; Approaches to creating portfolio company value through responsible investment



Reducing costs and liabilities

For example:

- reducing potential liabilities, such as those stemming from environmental contamination
- using resources (e.g. energy and water) more efficiently
- avoiding increased capital or operating expenditures by proactively identifying damaging environmental or social conditions
- increasing resiliency of the firm to avoid disrupted operations
- ensuring access to capital

Increasing revenue

For example:

- identifying new, sustainable product lines
- attracting and retaining top talent through strong company values
- acquiring new customers as a result of better brand image
- increasing the competitiveness of the company due to brand positioning.
- increasing engagement, and therefore productivity, of the workforce

1 PRI (Jan 2020) What is responsible Investment?

MYTHS and FACTS

About getting started with Responsible Investment in

PRIVATE EQUITY

MYTH #1

Responsible investing necessitates an exclusionary approach

FACT #1

There are many responsible investing methods and strategies available outside of exclusionary screens. Investors are encouraged to select approaches consistent with their investment strategies.

The practice of identifying and assessing material risks - ESG or other - in a potential investment may lead a GP not to pursue a specific target. The avoided investment is a result of a systematic consideration of risk and return – not a value-based screen.

MYTH #2

We cannot do ESG because we invest in a sector that has negative ESG impacts

FACT #2

Encouraging better practices in high impact sectors can result in mitigating or avoiding material risks.

MYTH #3

If I ask about a GP's ESG practices and principles, top quartile GPs won't want me as an LP

FACT #3

ESG is already on the radar of, if not actively considered by, a growing number of GPs. One private equity survey reports that 81% of respondents report on ESG efforts to their board at least annually.[2] In fact, GPs play an important part in awareness-raising for LP investment teams: when leading PE firms talk proactively about the value of their responsible investing approach, they help convince LPs that this is a standard part of excellence in private equity fund operations.

From a global perspective, participation in responsible investment has grown to the point where ESG questions are no longer unusual. For example, the TCFD[3] has support from 833 organisations, including LPs. PRI signatories now number over 2,800 including 500 asset owners.

2 PWC (2019) Private Equity Responsible Investment Survey
3 Taskforce on Climate Related Disclosures (June 2017)

FACT #4

Various country specific opinions (eg. The Freshfields 2005 report, 2015 ERISA guidance from the U.S. Department of Labor) are summarised in PRI's 'Fiduciary Duty in the 21st Century'. These determine that integrating ESG considerations is "Failing to integrate ESG issues in investment decision-making is a failure of fiduciary duty".[4] Read more here.

MYTH #4

Looking at ESG factors is not part of my fiduciary duty. My goal is to deliver a certain rate of return or pay pensions, not to deliver social change

MYTH #5

We are a small team and it takes a lot of resources to be a responsible investor

FACT #5

There is no standard format to implement responsible investing and getting started can be as simple as collecting information and putting questions to GPs. Additionally, there are many action items that can be done with minimal resources that leverage processes, people and relationships already in place.

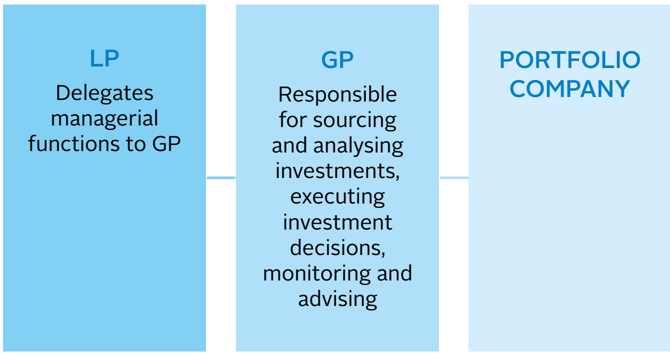
Eventually, it may be necessary to acquire more resources, but this should not be done until the responsible investing beliefs and goals are defined and well established.

4 Freshfields (2005), A legal Framework for the integration of ESG; UNEP FI (2015) Fiduciary Duty in the 21st Century; The Kay report (September 2011); CCLI (April 2018) Canadian fiduciary duties and disclosure obligations in the climate change context

RISK MITIGATION

LPs generally remain at arm's length from their private equity investments (See Figure 2). Often this means making a fund commitment decision largely based on the GP's internal processes and systems. For LPs, it is therefore prudent to seek assurances that the GP will be able to manage future ESG risks within an investment or due diligence process.

Figure 2; LP, GP and portfolio company relationship model



There are also some considerations which are specific to private equity that will influence the introduction of ESG policies and processes by LPs and GPs.

BLIND POOL INVESTING

Traditional fundraising in private equity requires LPs to make a blind pool commitment to a fund lifecycle of 7-10 years before the underlying assets are known. Private equity is a buy-to-sell model, not buy-to-own with the average holding period for a portfolio company is 3-7 years with all investments exited within the life of the fund. Therefore, LPs must undertake diligence of a GP's responsible investment policies and procedures such as monitoring and reporting prior to fund commitments. If available, LPs may need to look to previous fund vintages for examples and engagement topics when doing their due diligence on the GP. If not, then there is a greater reliance on statements of intent and policies. See Section 3 module 3 for guidance.

STRUCTURE: LIMITED PARTNERSHIPS

GPs have complete discretion over investment decisions and ownership activities for legal and practical reasons. However, a distinction can be made between influencing a decision and influencing a decision-making process. LPs should monitor and, where necessary, engage a GP about the policies, systems and resources used to identify, assess and make investment decisions with respect to ESG risk and opportunity. See Section 3 module 4 for guidance.

THE ROLE OF INTERMEDIARIES

When working with investment intermediaries—such as an Outsourced Chief Investment Officer firms (OCIOs), investment consultants or fiduciary managers - the onus remains on LPs to ensure the implementation of responsible investment strategies. Investment consultants play a key role in the formulation and review of investment goals, as well as the monitoring and oversight of investment managers. However, expertise and practice regarding ESG investing varies greatly even within a firm. LPs can address responsible investing during the selection process and in contracts.

Success with an OCIO can often be dependent on the Investment Committee's commitment to prioritising responsible investing. For ESG integration across asset classes, investment Committees need to consistently and vocally express their interest. This may mean regularly asking about implications for long-term risks and highlighting areas of concern in order to encourage OCIOs to engage with managers. Increased monitoring by an OCIO can increase transparency provided by managers. LPs have found that this level of engagement prompts an OCIO to evolve their ESG approach.

ILLIQUID ASSETS

Capital is usually deployed into a concentrated number of portfolio companies that are relatively illiquid versus other asset classes. Although the secondary market has matured significantly over the past ten years, an LP cannot easily sell its interests, and such sales often require permission from the GP. Any changes to the investment mandate may require negotiating with other fund investors. Actively reviewing a GP's policies during the diligence phase can help to ensure ESG factors are incorporated into an investment process. LPs and GPs should also be prepared to change how ESG factors are managed, depending on prevailing market conditions and financial performance of portfolio companies when the capital is drawn down. See Section 3 module 4 for guidance.

Figure 3; A modern understanding of fiduciary duty

A MODERN UNDERSTANDING OF FIDUCIARY DUTY

As processes and approaches used to guide investment decisions[5] have changed over time, so too has the notion of fiduciary duty.

Our report, Fiduciary Duty in the 21st Century: Final Report, puts forward a modern definition of fiduciary duty. This report describes how the integration of ESG issues into investment practices and decision-making is an increasingly standard part of the regulatory and legal requirements for institutional investors. Additionally, the report provides an overview of landmark studies on how ESG issues impact investment value. These studies can support LPs' internal discussions on responsible investment.

These features of the private equity market mean that approaches to the PRI's Principles may incorporate a range of actions for LPs and GPs.

Figure 4; Applying the PRI Principles to Private Equity

PRI Principle	Actions for Limited Partners	Actions for General Partners
Principle 1: We will incorporate ESG issues into investment analysis and decision-making processes	Factor responsible investment considerations into fund selection, fund terms, and fund monitoring processes.	Identify material ESG factors in pre-investment processes that might affect returns. Ensure ESG is deeply rooted in investment approach by teams.
Principle 2: We will be active owners and incorporate ESG issues into our ownership policies and practices	Within limited liability status, set up parameters for how LPs might engage with portfolio company management. Also engage with the GP on ESG considerations in their corporate policies. Post-acquisition, LPs should remain engaged through appropriate monitoring and GP reporting.	Establish processes to understand and manage material ESG risks and opportunities in partnership with portfolio company management.
Principle 3: We will seek appropriate disclosure on ESG issues from the entities in which we invest	Request information from GPs about their responsible investment practices and the ESG characteristics of underlying fund investments.	Implement monitoring processes to assess portfolio companies' management of ESG factors.
Principles 5: We will work together to enhance our effectiveness in implementing the Principles	Collaborate with peers and GPs to build consensus around responsible investment practices in private equity, leveraging PRI resources.	Collaborate with peers and LPs to build consensus around responsible investment practices in private equity, leveraging PRI resources.

5 Uniform Prudent Investor Act (1994), 7B U.L.A. 16 (Supp. 1995)

CAPACITY BUILDING FOR BEGINNERS

For an LP, we have identified five actions or first steps designed to leverage existing knowledge and processes.

1. START A DIALOGUE WITH YOUR GPS

WHAT THIS IS:

To increase the organisation's internal knowledge of the current ESG landscape and activities by investment partners, LPs have found it helpful to engage in dialogue with their GPs. GPs often have their own beliefs and goals with respect to responsible investing. These can span the range from merely addressing a specific issue within an existing fund vehicle, to creating individual segregated impact funds. The intent of this dialogue is to learn from the GP's own responsible investing journey and become familiar with their existing responsible investing practices. For monitoring and assessing your GPs on responsible investing, please see Module 4: Monitoring & Reporting.

OBJECTIVES:

- Understand a GP's approach to ESG issues
- Establish a baseline of understanding of current GP practices
- Build a long-term relationship with the GP on responsible investing

HOW TO DO THIS:

Dependent on the strength & length of the relationship plus the GP's resources, there are several ways to open a dialogue with your GP. Actions could include:

- Asking for the GP's opinions on ESG standards, e.g., SASB guidance, or industry standards
- A review of any of the GP's existing responsible investing-related documents or policies
- Raise questions at the Limited Partner Advisory Committee (LPAC)

THINGS TO CONSIDER:

Dialogues with GPs can be an iterative process. An LP's understanding of the GP's responsible investment practices, as well as the LP's own responsible investment beliefs and goals, will evolve over time. GPs responsive to LP requests may start to voluntarily include ESG material in their communications. The LP should be clear that they are not requesting changes to the GP's investing or reporting practices, but are in the information gathering stage.

2. LEVERAGE THE WORK ACROSS AN ORGANISATION

WHAT THIS IS:

There are transferrable principles and processes from other asset classes, investment processes and peers.

OBJECTIVES:

- Build information sharing networks between private equity teams and those of other asset classes
- Use insights from other asset classes to test ideas or as a basis for discussion with private equity GPs and other actors.

HOW TO DO THIS:

This is mainly an internal exercise for LPs who belong to larger investment organisations managing different asset classes. Knowledge sharing may either be informal (interaction between investment teams) or formal (official committees such as a responsible investing committee including all asset classes).

THINGS TO CONSIDER:

Asset classes are traditionally siloed and have their own unique characteristics. Work is to identify and modify transferable lessons.

3. ENGAGE WITH INDUSTRY PEERS AT OTHER LPS

WHAT THIS IS:

According to recent reporting data, the number of LP PRI signatories exceeds 350, investing $1.1 trillion via externally managed private equity funds. This would indicate that LPs can gather and benefit from interaction with other LPs.

OBJECTIVES:

- Understand practices at other LPs and GPs
- Identify potential collaborations on responsible investing topics, such as GP engagement, reporting, documentation and due diligence approaches

HOW TO DO THIS:

Involvement in collaborative initiatives can afford the opportunity to network with peers and learn from their experiences. Another thing to keep in mind are other LPs on LPACs who have raised these issues in the past.

THINGS TO CONSIDER:

Building a responsible investing relationship with fellow LPs may have the advantage of building stronger coalitions on LPACs. It may also afford you the advantage of knowing about emerging initiatives and the opportunity to take part.

4. REVIEW RESOURCES AND LEVERAGE EXISTING TOOLS

WHAT THIS IS:

Increased interest in responsible investing has also led to the development of several valuable public tools for different stages of the private equity investing process, from diligence to monitoring.

OBJECTIVES:

- Identify existing public tools and practices that can be adopted with internal resources
- Gather ideas for aspirational goals based on current market practices or internal processes

HOW TO DO THIS:

PRI and Institutional Limited Partners Association ('ILPA') are two main resources for RI in private equity. These complementary industry initiatives cover topics such as governance and provide tools and practices which might be tested with investment teams. Please see a list of resources in Appendix 2.

THINGS TO CONSIDER:

While this approach is helpful for organisations with few internal resources, there will still need to be some internal work done to modify tools to suit the LP's unique investment practices. While an organisation may not be prepared or want to use existing tools, they may provide ideas for future initiatives or new funds.

5. IDENTIFY AND BUILD CURRENT ESG PROCESSES

WHAT THIS IS:

Many investment practices that are not labelled "ESG" or "responsible investment" are still relevant as investment professionals realise that environmental and social issues are material or just good investment practice. In many cases, responsible investing practices have been spearheaded by individuals in companies who may be a sector expert or have a personal interest, but these practices have not been systematised across the organisation

OBJECTIVES:

- Engagement of internal personnel in the responsible investing discussion
- Demonstrate that ESG can be a good investing practice
- Explain terminology

HOW TO DO THIS:

A mapping out of company practices around typical ESG issues will often identify existing practices.

- Analyse existing practice among investment teams and committees
- Perform a gap analysis

THINGS TO CONSIDER:

Investors may have preconceived ideas of responsible investing and may require effort to understand what practices fit into a responsible investing program.

SECTION 2:
RECENT DEVELOPMENTS

This section covers developments since the 2ND Edition in 2011 including:

- Key drivers of increased interest in ESG issues such as regulatory, industry and legal changes.
- Increasing coverage and discussions on specific issues such as gender diversity and climate change.
- Reputational risk awareness has also heightened.
- Changes including reporting and industry collaboration.

Recent key developments and trends that impact the landscape in which LPs address ESG issues include expanded and increased:

- Expectations in regulatory and legal guidance
- ESG awareness throughout industry actions and perceptions
- Competition for LPs (with respect to accessing PE funds)
- Employee expectations that they work for an investor with established responsible investment practices
- Leadership from the board or management, meaning ESG issues are rising up the corporate agenda
- Staying abreast of general industry practices, the desire to avoid negative press attention
- Increasing recognition and identification of material ESG factors.

These are expanded upon in greater detail to the right.

REGULATORY AND LEGAL DEVELOPMENTS

An increasing number of national and supranational regulatory initiatives place the onus for addressing ESG impacts on public and private corporations. Such regulatory developments highlight how ESG issues, once considered non-material or solely reputational risks, are now assessed as investment risks. For example, recent supply chain regulation and legislation, including California's Transparency in Supply Chains Act, The Dodd-Frank Act and the UK's Modern Slavery Act, now require firms to account for and monitor specific human rights-related concerns in order to access certain markets. As an example, California's Transparency in Supply Chains Act requires any manufacturer or retailer with over $100 million in California sales to disclose efforts to eradicate slavery and human trafficking from their direct supply chains

This has heightened the need for ESG risk assessments and due diligence; and ultimately, disclosure. Several governing bodies require that LPs meet mandatory requirements for disclosure on responsible investing.

In North America, the Ontario Pension Benefits Act of 2016 requires[6] pension plan administrators to disclose whether, and how, they incorporate ESG factors into their investment practices. This trend will continue as countries look to initiatives such as the Task Force on Climate-related Financial Disclosures (TCFD) recommendations as a basis for reporting on climate related risk.

INDUSTRY EVOLUTION

Awareness and understanding of material ESG issues such as climate change, employee issues and board diversity[7] continues to rise. This has led to the increasing adoption of fund-wide responsible investment approaches among asset owners.

6 Section 78(3) of Regulation 909 (the Regulation) under the Pension Benefits Act (PBA)

7 Linda-Eling Lee et al MSCI, (November 2015) Women on Boards: Global Trends in Gender Diversity on Corporate Boards

Figure 5; Evolution of an ESG Issue – An Example

The increased understanding of the seriousness of sexual misconduct in the workplace has led to stronger repercussions for perpetrators than previously seen. The potential legal risks and long-term liabilities have prompted investors to respond with protective measures; a "Weinstein clause" is now added to deals to preclude limited partners and general partners from any associated financial impacts.

The interviewees for this guide identified other related drivers such as the desire to retain a leadership position among peers, board leadership, or a response to stakeholder pressure.

ESG staff at LP organisations find they now operate in an industry culture where the concepts of ESG and responsible investment are no longer marginal or second thoughts. For example, one LP interviewed during research for this report stated the increasing and informed media coverage of responsible investing by mainstream financial publications was an important contributor to the growth. LPs now report that GPs engage in conversations around ESG issues more frequently than in the past and that the absence of an ESG policy is now unusual. This marked shift raises baseline expectations for ESG practices. Increased familiarity with responsible investment also allows for a more advanced starting point for internal discussion among investment staff at an LP or GP.

Figure 6; Example - Reputational risks leading to GP engagement

For some limited partners, direct exposure in private equity investments that benefit from catastrophes, like Hurricane Maria in Puerto Rico, led to investment staff's examination of whether the implications of ESG risks have been accounted for in a private investment. Resulting engagements with GPs have led to moratoriums on foreclosures in the case of Puerto Rico and a hardship fund for laid off workers when limited partners were concerned about the negative financial repercussions stemming from impacts to local economies and the fund's reputation. Media coverage and stakeholder pressure, around investments in private prisons have also led to issue-specific engagements with GPs.

There are other key changes relating to various areas of the PE market that have developed since the last report in areas of competition, reporting and collaboration.

INCREASED COMPETITION AND COMPLEXITY

LPs are also investing in an increasingly competitive market. Access to top performing funds is constrained due to rising allocations to private equity and record numbers of over-subscriptions. Consequently, there may be a perception among some LPs that raising ESG issues with GPs might restrict access. However, anecdotal evidence from industry suggests that dialogue-based approaches do not limit LPs' access to funds[8]. Moreover, top quartile GPs are increasingly practicing responsible investment and frequently disclosing this information.

REPORTING

LPs need to provide clear direction on reporting requests to avoid anecdotal or inconsistent information which lacks standardisation. LPs need to ensure a systematic approach to reporting that clearly defines reporting objectives and sets out processes on how to utilise the data.

The development of industry guidelines such as SASB and the EU proposed taxonomy are two important changes in the market since the publication of the first guide.

INDUSTRY COLLABORATION

Various collaborative cross industry initiatives (see appendix 2 for further details) have been developed since the 2nd edition of this guide. These have enabled LPs to develop more sophisticated questioning, understanding and approach to due diligence beyond "do you have a responsible investment policy?" to "how is that policy implemented?" and "can you demonstrate performance?".

Collaboration across the industry to achieve industry standards or frameworks will continue to develop the practice of responsible investment in the private equity industry. Moving towards a common dialogue or taxonomy will streamline the exchange of ESG information and benefit both LPs and GPs.

8 ILPA Principles 3.0 (2019) https://ilpa.org/wp-content/uploads/2019/06/ILPA-Principles-3.0_2019.pdf

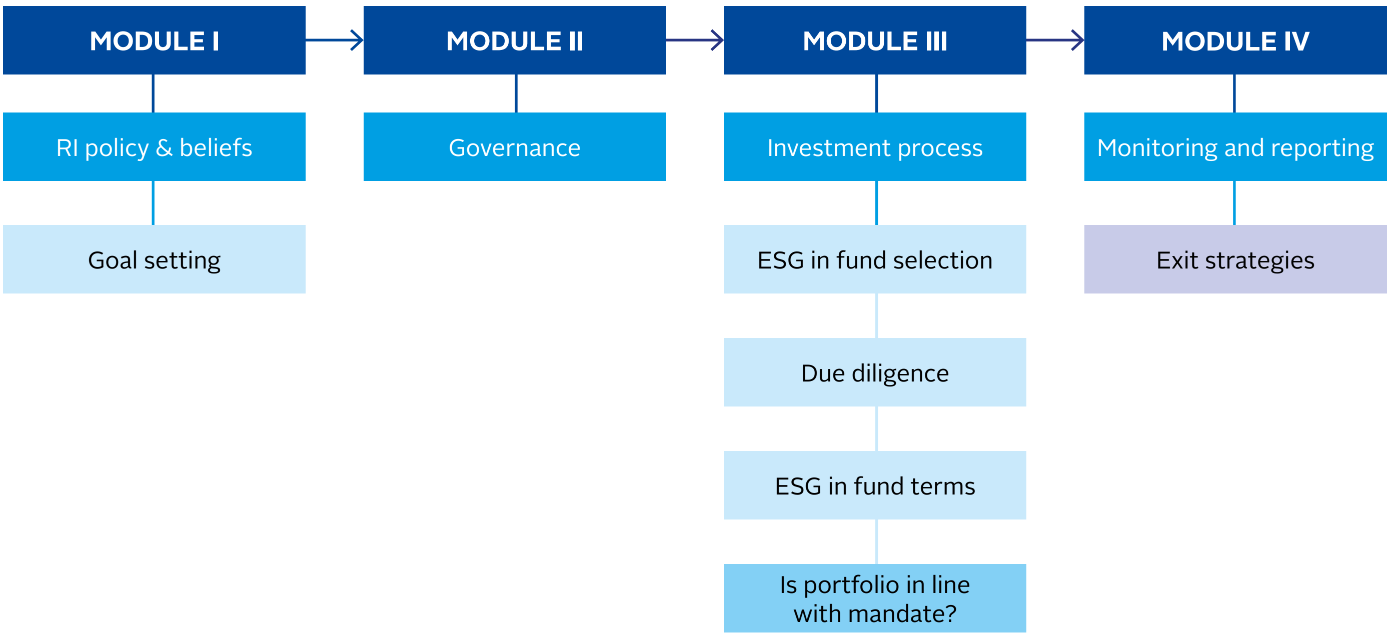
SECTION 3:
INTEGRATING ESG

This section looks at all stages of the investment process in private equity and draws on other PRI and industry guidance to provide suggested approaches.

- Module I covers elements such as investment policies and approaches and how responsible investment can be integrated.
- Module II discusses different points where responsible investment intersects with governance.
- Module III looks at the investment process focusing on diligence process and fund terms.
- Module IV is concerned with the monitoring during the life of the fund and exit

This section outlines approaches that might be undertaken at various stages of the investment process. It follows the structure of the PRI Reporting and Assessment framework

Figure 7; Integrating ESG into the investment process



Module	Explanatory notes
Module I: RI Policy, Beliefs and Goal Setting	Establishing how the organisation views ESG issues and the goals of their responsible investment practice is helpful in sending a consistent message to the organisation and investment partners
Module II: Governance	ESG considerations in specific governance constructs
Module III: Investment Process	The implementation of your responsible investment practice leading up to and executing the investment decision. Challenges, tools and resources are highlighted in this module
Module IV: Monitoring and Reporting	Monitoring and reporting of performance and initiatives at portfolio companies and GPs

MODULE I: RESPONSIBLE INVESTMENT POLICY, BELIEFS AND GOALS

POLICY

As discussed earlier in the Section 2, an investor may have multiple drivers for introducing an RI policy – materiality, clients, risk management and regulation. These drivers may result in policies relating to "responsible investment", "sustainability", or "ESG".

Clarity on **why** your organisation is interested in responsible investing is key for developing an organisations' approaches and criteria for decision-making. This can then be articulated in the investment policy and/or as a separate investment process. Additionally, clear policies allow for consistent messaging to key internal and external stakeholders such as investment teams, GPs, co-investment partners, beneficiaries and clients. This is helpful for GPs where they are fielding requests from LPs on RI issues. Here are three recommendations on how to establish and integrate ESG policies:

Recommendation 1

Define and integrate RI beliefs into a broader set of investment policies or approaches. Steps and considerations may include:

- Promoting organisational clarity on why these matters are important.
- Developing definitions of what ESG means for your investment mandate, strategy and products.
- Defining a principle-based approach as these definitions may change as your understanding changes.
- Identifying different objectives throughout your organisation, such as risk mitigation or investment opportunities

Recommendation 2

Develop ESG policies early in the process which can:

- Drive implementation and enable your organisation to quickly and effectively implement responsible investing practices.
- Build consensus and clarity amongst the investment team.
- Be used to establish the scope of a specific policy.

Recommendation 3

Invest in internal education and capacity building for the investment team which can:

- Ensure investment teams always ask consistent questions which are focused on material ESG issues.
- Provide Ideas for internal education and capacity building which could include a speaker series and use of off-the-shelf courses.

GOAL SETTING

Setting goals (aspirational, interim, qualitative or quantitative) is an important part of developing a coherent responsible investment strategy. Setting of goals remains an exercise in judgement to find ones that are consistent with the LP's corporate beliefs, and are realistic and acceptable across both management and board teams. Goals might be set using 1) existing standards from industry organisations and/or 2) following industry peers. Leveraging off existing industry goals or practices has the advantage of:

- Being able to position your organisation as a "fast follower"
- Leveraging work that has clear reasoning and credibility
- Alignment with industry consensus

In either case, the LP will usually have to adapt existing resources and standards to their investing strategy, products, client requirements and internal systems.

MODULE II: GOVERNANCE

LPs are encouraged to seek guidance on private equity fund governance best practice from the Institutional Limited Partners Association's (ILPA) recently published *Private Equity Principles 3.0 (2019).*[9] The third edition of the ILPA Principles now reflects ESG considerations as a standard part of LPAC procedure and fund disclosures. Areas covered include:

Notifications and Policy Disclosures:

Among the notifications and disclosures that GPs should provide to investors on material developments that impact the fund, the ILPA Principles includes a section on ESG Policies and Reporting. It states that an ESG policy *"should include information sufficient to enable an LP to assess the degree to which the GP's investment strategy and operations are aligned with an individual LP institution's ESG policies, including how ESG is factored into due diligence as well as incident disclosures and performance reporting. The policy should identify procedures and protocols that can be verified and/or documented, rather than a vague commitment of behaviour".* The ILPA Principles also includes *"incidents presenting potential breach of ESG policy or code of conduct"* in the list of notifications that should be provided to LPs on occurrence or disclosed upon request.

Limited Partner Advisory Committee:

The ILPA Principles propose a list of matters which fall under the mandate of the LPAC, including "Reviews of any material ESG incidents and/or risks to the fund's portfolio" and includes "ESG reporting" on the list of recommended elements of an LPAC agenda (although this is subject to the GP's discretion).

Figure 8; The role of the LPAC

THE ROLE OF THE LPAC IN FUND GOVERNANCE

As stated in ILPA Principles 3.0, the LPAC plays a critical role in fund governance, by providing a sounding board for the GP, and serves as an important source of input on critical governance determinations; in particular conflicts of interest.

Common objectives of every LPAC should include: facilitating the performance of the advisory board without undue burden to the GP; creating an open forum for discussion of matters of interest and concern to the partnership while preserving confidentiality and trust, and providing sufficient information to LPs so they can fulfil these responsibilities. ILPA notes that it should be part of the LPAC's mandate to review any material ESG incidents and/or risks to the fund's portfolio.

Expenses Fully Offset or Covered Under the Management Fee:

The ILPA Principles note that, as a general rule, any third-party expenses incurred in the provision of services that typically would be provided by the GP to similar funds should be offset against the management fee. ESG-related expenses are included under this rule, and are regarded in the same way as general due diligence consulting costs. It is noted that if specialised consultants are required to fulfil specific LP requirements, any resulting fees should be paid by the requesting LPs.

In places, the ILPA Principles reflect aspirations as well as existing market practice for fund governance. In setting out Principles 3.0, ILPA puts forth that careful consideration of each of these preferred private equity terms and best practices will result in better investment returns and a healthier private equity industry. ILPA outlines it is *"imperative to the health of the private equity ecosystem that market actors adhere to the highest ethical and professional standards, deal fairly and honestly, invest responsibly and act with integrity and transparency".*

ILPA has also incorporated responsible investment considerations into their core reporting guidance documents:

Due Diligence Questionnaire:

The ILPA *Due Diligence Questionnaire* (DDQ) standardises the most frequent and important diligence questions posed by investors. Under Section 10, the ILPA DDQ incorporates the PRI Limited Partners' Responsible Investment Due Diligence Questionnaire as the industry standard for ESG-related fund due diligence.

Portfolio Company Metrics Template:

The ILPA *PortCo Metrics Template* proposes an efficient and comprehensive format for reporting details about individual companies held by an LP's fund investments. It includes a voluntary ESG section, which is aligned with PRI's own work on ESG reporting over the lifetime of a fund. If the GP is following PRI guidelines on reporting, they should have the suggested "framing" data for each portfolio company in place. For example: Does the company have an ESG/sustainability policy? Is it being monitored on ESG by the GP? Is there a resource in place at the portfolio company to implement the policy? See for more information.

9 The Institutional Limited Partners Association (ILPA) (2109) Private Equity Principles 3.0. www.ilpa.org

MODULE III: INVESTMENT PROCESSES

The PRI has developed dedicated resources to support LPs and GPs with incorporating responsible investment considerations across three investment stages: fund due diligence, fund commitment and fund reporting.

Figure 9; Three Stages of Private Equity Investment Process

FUND DUE DILIGENCE

Fund Due Diligence will establish a standard or benchmark from which LPs and GPs can built a solid understanding.

FUND COMMITMENT AND TERMS

A focus on terms and commitments will help to establish alignment of interest.

FUND REPORTING

Fund reporting will enable clients to clearly understand how policy or goals align with practice.

FUND DUE DILIGENCE

An LP is a passive partner in the management of a fund. After an LP has committed capital to a fund, the GP has sole discretion for investment and ownership decisions. Therefore, before investing in a fund, an LP should assess the degree to which a GP has clear policies, strong governance systems and sufficient resources in place needed to integrate ESG considerations into its investment practices. Prior to investing, an LP should also discuss ESG-related disclosures that the GP will provide during the life of the fund.

An LP may consider investing with a GP that does not provide adequate responses during the due diligence process if they believe the GP has the willingness and capacity to elevate their efforts during the life of the fund. In such cases, recognition by the GP of the importance of ESG issues and/or a formal commitment to improve its approach to responsible investment, and report on its progress to the LP, might be expected before making a capital commitment to a fund.

Beginning Due Diligence

A GP's Private Placement Memorandum, Offering Memorandum, or any introductory marketing materials may allow an LP to establish whether a GP's fund mandate addresses ESG considerations.

LPs may want to review any publicly available information on the GP's approach to responsible investment at this initial stage or, if the GP is a PRI signatory, LPs can review their latest public Transparency Report on the PRI website. Initial stages might also include consideration of the investment approach or process undertaken by the GP; for instance, does the fund target specific sectors or geographies that are associated with specific ESG risks such as energy or utilities.

Detailed Due Diligence

The PRI recommends that LPs use the PRI Limited Partners' Responsible Investment Due Diligence Questionnaire as a starting point for assessment. The PRI proposes this questionnaire as a standard format for ESG due diligence and it has been incorporated into the ILPA *Due Diligence Questionnaire.* The DDQ is not intended to be used as a checklist, but as a tool to establish dialogue and that the approach used might depend on the GP's strategy, size, experience and resources. The questions or responses may form a basis for engagement, either pre- or post-commitment and GPs have reported that receiving feedback from an LP on the answers provided in the DDQ would be helpful. The PRI DDQ has an accompanying guidance document which guides both LPs and GPs on how to enhance discussions during due diligence.

Considering the diverse nature of the private equity asset class, an LP should also discuss with the GP how their approach to ESG integration is influenced by their investment strategy, by establishing responses to the following types of questions: How does your approach to integrating ESG factors vary depending:

- On whether you make a minority or control investment?
- Upon the sector or stage of company growth cycle that you might target?

Different funds will have different exposures to ESG-related risks and opportunities, and different GPs will have different capacities, leverage and management approaches for addressing ESG issues. An LP should take these considerations into account when assessing the GP's responses to the *LP Responsible Investment DDQ* and during the ensuing dialogue.

Fundraising cycles

Private equity is a relationship-based business and GPs typically rely on existing investor relationships when raising successor funds. Private equity funds, on average, return to market to raise successor funds three to four years after closing a predecessor fund. Many typically secure capital at the same rate as deploying it.[10] This may present a challenge to LPs looking for prior examples of how the GP has fulfilled their responsible investment commitment in prior funds.

Incorporation into operating plans

The post-transaction plan, typically called the "100-day plan", is a critical period to determine whether the investment evolves from potential to performance. It is also an excellent opportunity for material ESG risks and opportunities to be prioritised. However, ESG issues that are not immediate concerns may be integrated into the longer-term business strategy for the portfolio company. LPs should seek to understand the GP's approach to integrating ESG into both plans.

Emerging markets vs developed markets

An LP should consider factors specific to emerging markets such as:

- Private equity investments in emerging markets often do not involve the same level of ownership and control, increasing the importance of aligning interests with other investors and company management.
- A GP may not be able to access the same scope and volume of audited information in its due diligence process.
- There may also be differences in the regulatory regimes for ESG issues requiring compliance above legal requirements.

While emerging markets may have risks not common in developed markets, GPs investing there may also have more experience with ESG factors. Development finance institutions (DFIs), for example, play an important role in the emerging market LP community. DFIs have historically used detailed ESG-related performance requirements and engaged with GPs on ESG factors and are often regarded by other LPs as an anchor investor in the fund. The presence of a DFI may give a level of assurance that ESG factors are being duly considered by the GP.

Different Private equity structures

Below are three common private equity structures with ESG considerations. This is by no means exhaustive but serves to demonstrate the different implications for the due diligence process.

10 Preqin (November 2019), Private Equity Fundraising Cycles

Figure 10; Considerations for select private equity structures

Funds of funds	Secondaries	Co-investments
Funds of funds are typically well-resourced and very experienced at investing in private equity, and therefore have the potential to more effectively oversee and influence a GP's approach to ESG integration. When investing in a fund of funds, an LP should have assurance that there is a thorough process in place to assess and monitor the underlying funds on their approach to responsible investment. An LP could ask that the fund of funds manager uses or completes the *LP Responsible Investment DDQ* as a basis for ESG due diligence on the underlying funds or during fund raising.	ESG due diligence can be undertaken on underlying portfolio companies prior to investment because, unlike a primary fund investment, -- where capital is committed to a blind pool-- the portfolio is already known. When investing in PE secondary funds, an LP should have assurance that there is an appropriate process in place to screen for any material ESG risks before the secondary fund acquires stakes in existing portfolios, and that the secondary fund has a process in place to monitor its underlying investments on ESG risk. An LP could also ask secondaries fund managers to complete the *LP Responsible Investment DDQ* during fundraising (noting that Section 3 may not be applicable).	Co-investments give an investor increased direct exposure to both the upside and downside of a private investment, and offer a greater level of insight and direct influence over ESG integration. The LP may participate directly in the due diligence process, may be able to appoint a board member and have better access to portfolio company information.

FUND COMMITMENT AND TERMS

The Limited Partnership Agreement (LPA) and associated legal documents outline the fundamental terms governing the operations of the fund, including the rights and responsibilities of the parties. In addition to partnership economics, the LPA covers several important aspects affecting the alignment of interests between the LP and the GP, such as control and governance, conflicts of interest and transparency. LPs are increasingly seeking a more formal, structured and binding approach to ensure their own understanding of the GP's commitments to responsible investment is upheld.

Whilst some GPs will include ESG provisions in their fund terms as standard, others may not do so unless requested by LPs. However, a lack of consistency in requests from LPs results in a proliferation of side letters, which are difficult to manage and prolongs negotiation. If external counsel is not adequately briefed or is unfamiliar with the LP's RI objectives, this may result in ESG provisions being simplified, misinterpreted or diluted. The PRI has provided guidance on incorporating RI guidance into PE terms. Published in 2017, the guidance identifies current and emerging best practice, as well as potential constraints, and offers practical options to LPs and GPs reconsidering how they might incorporate responsible investment into fund terms.

Despite constraints, if a GP has made a formal commitment to responsible investment then it can be argued that they should be prepared to reflect this in the fund terms. It demonstrates the seriousness of the GP's commitment and should assist the GP to achieve systematic uptake of ESG by the whole firm.

Though unusual, some LPs have negotiated separate side letter agreements with certain investors. This can be made available to other LPs in the fund through the most favoured nation provision found in many LPAs, though it may only be available to those with the same or greater levels of capital commitment. There is a range of approaches to this in the market and the PRI guidance outlines the advantages of either approach.

Figure 11; [PRI guidance and Legal opinion benefits][11]

> Legal firm Baker McKenzie has commented on the PRI guidance, reasoning that "it is arguably more appropriate for generally applicable provisions to be set out in the LPA, if they do not result in materially more obligations on the fund manager. The benefits of this approach are that it:
>
> - Reduces the number of side letter provisions granted.
> - Reduces the negotiating time and cost.
> - Demonstrates that the fund manager is alive to investor concerns.
> - Demonstrates goodwill to investors or gains negotiating leverage for the fund manager.
> - Increases the level of transparency for the benefit of all investors in the fund.
> - Bolsters the relationship between the investor and the fund manager.

Bespoke provisions (such as on reporting requirements, certain investment restrictions or opt-out provisions) could be negotiated with the specific LP through a side letter and renegotiate if required.

Whichever approach is taken, ESG provisions could be split into these overlapping categories to inform dialogue with external counsel:

- Commitments to ESG policy or standards, and compliance with ESG-specific regulation
- Investment restrictions, and/or excuse or opt-out rights
- Investment decision-making processes
- Providing ESG reporting and incident reporting to investors

MODULE IV: INVESTMENT PROCESSES

This Module summarises the guidance in PRI's ESG Monitoring, Reporting and Dialogue in Private Equity guide. which aims to:

- Support LPs in developing their own monitoring practices and enhance their effectiveness
- Support GPs to anticipate and respond to increasing ESG-related monitoring requests from LPs
- Help facilitate dialogue and improve understanding between GPs and LPs on the topic of ESG disclosure through case studies and good practice examples

Many funds establish an LP Advisory Committee (LPAC) to enable a GP to effectively engage and communicate with LPs with overall responsibility for decision-making remaining with the GP. LPs often monitor GPs on ESG integration to better understand portfolio operations and to gain assurance that the GP is fulfilling its commitments to responsible investment practices made during all stages of the investment, fundraising and exit process. This mechanism might be through the LPAC.

As private equity is a trust-based system, LPs rely on GPs to monitor ESG issues within the portfolio, and furthermore that the responsibility and knowledge to manage these issues lies largely with the portfolio company management. But as stewards of their capital, LPs are entitled to monitor GPs' performance in line with their responsible investment strategies and beliefs.

PREPARING TO MONITOR

When preparing to monitor a GP, LPs may want to consider:

- **Purpose -** What information do I need to monitor ESG within my fund(s)' portfolio(s)? Why is it important; What ESG information matters to my stakeholders?
- **Frequency –** what reporting frequency do I require from the GP?
- **Feasibility -** Is the ESG information requested unique? What additional resources might be required?
- **Impact -** How will the information be used for future investment decisions? What feedback will I provide to GPs?
- **Change -** How might expectations have changed since making the fund commitment?
- **Published information -** How will the information be published and reported?

KEY MONITORING PRACTICES

Eight key LP monitoring practices emerged as recurring themes during the research for the PRI-ERM guidance and during the research for this guide. These themes cover:

1. **Exception-based reporting**
   For more static information, some LPs would prefer that the GP reports any changes on a by-exception basis rather than on a regular schedule.
2. **Using the LPAC and the Annual Investor Meeting**
   LPs may use governance structures already in place to monitor GPs on ESG integration. This practice has the added advantage of engaging other investors in the fund on the topic of ESG integration.

11 James Burdett & Jon Unger; Baker McKenzie (Nov 2017) RESPONSIBLE INVESTMENT IN FUNDS WITH AGE COMES RESPONSIBILITY

3. **Using monitoring templates**
Some LPs and funds of funds send proprietary standardised reporting templates annually to their GPs. This allows them to consistently collect information and track progress.

4. **Assessment and scoring of GPs**
In assessing GP practices, many LPs use the information disclosed to them to rate or rank GPs annually on their ESG practices.

5. **Using the PRI Reporting Framework**
PRI Reporting Framework combines mandatory and voluntary reporting. LPs can request a GP's private Transparency Report and Assessment Report.

6. **ESG incident monitoring**
Most LPs expect to be notified by their GPs in an open and timely manner about incidents that could have serious reputational or financial implications for their organisation.

7. **Reviewing GPs' internal ESG/CSR management and initiatives**
Some LPs monitor GPs on their internal commitment to management of ESG issues or corporate responsibility.

8. **GP Feedback**
GPs have emphasised the value of having LP feedback on the ESG information that they report to give them a better understanding of their performance, support internal objective-setting and help them to better understand the LP's responsible investment objectives and priorities

Underlying all these themes is the importance of dialogue; whether this is through systematic tracking, in-person dialogue, LPAC, through investment consultants or a deep-dive discussion into specific ESG issues or material incidents.

MONITORING AND REPORTING FRAMEWORK

The PRI has published extensive guidance on monitoring and reporting[12] ESG issues. The main areas are covered in the figure below.

Figure 12; ESG Disclosure Framework for Private Equity

I. POLICY, PEOPLE AND PROCESS

1.1 What updates have you made to your responsible investment policy/ guidelines and/or strategy?

1.2 What changes have you made to how responsible investment is resourced and structured at the firm?

1.3 How has your responsible investment policy/guidelines and/or strategy been implemented?

1.4 How does your firm manage the ESG aspects of its own operations (corporate responsibility)?

II. PORTFOLIO

2.1 What is the ESG risk and opportunity profile of the portfolio companies in the fund? Have there been any changes to the ESG risk and opportunity profile of the fund in response to emerging ESG issues, and, if so, which ones?

2.2 How are ESG factors managed by the portfolio companies in the fund?

2.3 Report specific ESG indicators for portfolio companies.

2.4 Describe your approach to assessing the risks and opportunities that climate change poses to your portfolio companies.

2.5 Describe your approach to assessing the environmental and social benefits created by your portfolio companies.

III. MATERIAL ESG INCIDENTS

3.1 Immediate notification of material ESG incidents.

3.2 Periodic summary of material ESG incidents.

12 PRI (2018) ESG monitoring, reporting and dialogue in private equity

There was also an industry initiative in 2013 which provided a broad framework for disclosure. This is outlined in figure 13.

Figure 13; ESG Disclosure Framework for Private Equity[13]

ESG DISCLOSURE FRAMEWORK FOR PRIVATE EQUITY

The *ESG Disclosure Framework for Private Equity (ESG Disclosure Framework),* published in 2013, was a cross-industry effort to establish LP objectives for ESG disclosure, both during fundraising and during the life of a fund. And to support a more structured approach to ESG disclosure in private equity from GPs to enable LPs to meet the eight objectives.

The *ESG Disclosure Framework* provides guidance on the rationale behind ESG-related questions from LPs, with the core premise that: "due to both the diverse nature of the private equity asset class and differing LP and GP approaches to ESG management and disclosure, what constitutes effective and relevant ESG disclosure can be defined only through discussions between a GP and its LPs in the context of the characteristics of a specific fund and with due regard to commercial confidentiality, legal privilege, liability, and resource constraints."

The *ESG Disclosure Framework* underwent a 16-month consultation and drafting process that involved a group of more than 40 LPs, 20 industry associations (including the PRI) and 10 leading GPs. It forms the basis for the PRI's guidance on LP-GP ESG information exchange during fundraising and the fund lifetime, presented in Module III and Module IV of this section.

Principles of disclosure

The PRI has identified some principles that may guide disclosure of ESG performance that LPs might make to GPs. These include:

- Reporting on a 'whole fund' basis.
- Alignment with existing financial reporting cycles.
- Disclosed information should be; accurate & credible; balanced & objective; comparable & consistent; complete & timely.
- Clear allocation of responsibilities and oversight for ESG reporting.
- Built on GP/LP dialogue to reflect changing LP reporting requirements.

There are other initiatives that cover monitoring and reporting. These include frameworks on disclosure from ILPA and PRI.

Figure 14; PE reporting initiatives

- The ESG Disclosure Framework for Private Equity was a cross-industry initiative that established Limited Partner (LP) objectives for ESG disclosure during (i) fundraising, and (ii) during the lifetime of the fund
- PRI: Due Diligence Questionnaire; an adaptable list of questions that LPs can give to General Partners (GPs) when fundraising
- ILPA: Due Diligence Questionnaire
- PRI: ESG Monitoring and Reporting Framework for disclosing ESG information to LPs during the lifetime of a fund
- ILPA: Portfolio Company Metrics Template
- PRI: 'Using SASB to implement PRI monitoring and disclosure resources for private equity'

13 Invest Europe (25 March 2013) ESG Disclosure Framework

ESG CONSIDERATIONS FOR EXIT STRATEGIES

Addressing ESG issues throughout the investment cycle can reduce the risks and enhance company value at exit.

- Identification and management of material ESG issues reduces the possibility a buyer will negotiate a lower price due to unforeseen risks
- Setting KPIs at the beginning of the holding period generates data to track improvements
- Thorough management of ESG issues can indicate a well governed business

In the case of an IPO exit, public market expectations for shareholder rights, board structure and ESG reporting have developed and better management of ESG issues during private ownership can help reduce issues during the IPO. For a trade exit, sound ESG management - ideally in line with the trade buyer's own standards - of a potential acquisition can increase the incentive for a deal. Integrating poor ESG performers can be burdensome for buyers with established corporate ESG practices and policies. On the other hand, good ESG performers can be seen to contribute to intangible corporate assets such as reputation and brand.[14]

Figure 15; PRI snapshot – exit strategy benefits

In Practice: ESG considerations at exit from PRI's 2018 Snapshot Report

- Consistent reporting can generate data to demonstrate in exit documents improvements created by ESG management during the holding period, such as decreases in employee turnover or lost time incidents
- ESG issues considered at exit included regulatory issues, impact on customers, impact on employees, earn-outs, competitive restrictions
- ESG Issues may be included in vendor due diligence documents or an IPO prospectus

14 PwC (December 2012) The Integration Of Environmental, Social And Governance Issues In Mergers And Acquisitions Transactions.

APPENDIX 1: EXAMPLES OF ESG FACTORS

EXAMPLES OF ESG FACTORS		
ENVIRONMENTAL	**SOCIAL**	**GOVERNANCE**
Air and water pollution	Customer satisfaction	Accounting standards
Biodiversity	Data protection and privacy	Anti-competitive behaviour
Climate change	Diversity and equal opportunities	Audit committee structure
Deforestation	Employee attraction and retention	Board composition
Ecosystems services	Employee engagement	Bribery and corruption
Energy efficiency	Government and community relations	Business ethics
Hazardous materials	Human capital management	Compliance
Land degradation	Human rights	Executive remuneration
Resource depletion	Indigenous rights	Lobbying
Waste management	Labour standards	Political contributions
Water scarcity	Labour-management relations	Risk management
	Marketing communications	Separation of chairman and CEO
	Product mis-selling	Stakeholder dialogue
	Product safety and liability	Succession planning
	Supply chain management	Whistleblower schemes

APPENDIX 2: SELECTED INDUSTRY RESOURCES

- AFIC: Développement Durable et Capital Investissement (English and French)
- AFIC: Charte D'Engagements des Investisseurs pour la Croissance (Download here)
- BVCA: Guide to Responsible Investment
- BVCA: Responsible Investment Toolkit
- BVCA: Walker Guidelines (on GP and portfolio company reporting) (Download the guidelines here)
- EVCA: Reporting Guidelines
- IIGCC: A Guide on Climate Change for Private Equity Investors
- ILPA: Private Equity Principles 3.0
- IOSCO: Private Equity Conflicts of Interest (Consultation document)
- SASB Materiality map
- ILPA DDQ
- ILPA Portfolio Company Metrics template
- CDC ESG Toolkit for Fund Managers
- CFA Institute Environmental, Social and Governance Factors at Listed Companies: A Manual for Investors
- ISO 26000 'Guidance on social responsibility'
- Global Reporting Initiative (GRI) Sustainability Reporting Guidelines. GRI has a new program to develop GRI Sector Standards. The first sectors to be developed will be oil, gas and coal, and agriculture.

UN conventions and initiatives

- UN Global Compact
- The Universal Declaration of Human Rights
- ILO Declaration on Fundamental Principles and Rights at Work
- The Rio Conventions
- The UN Convention Against Corruption

Other intergovernmental organisations

- OECD Guidelines for Multinational Enterprises
- OECD Anti-Bribery Convention
- OECD Principles of Corporate Governance

International financial institutions

- IFC Performance Standards
- Equator Principles

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The Principles for Responsible Investment (PRI)

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

More information: www.unpri.org

PRI Principles for Responsible Investment

The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

UNEP FINANCE INITIATIVE

United Nations Global Compact

The United Nations Global Compact is a call to companies everywhere to align their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to take action in support of UN goals and issues embodied in the Sustainable Development Goals. The UN Global Compact is a leadership platform for the development, implementation and disclosure of responsible corporate practices. Launched in 2000, it is the largest corporate sustainability initiative in the world, with more than 8,800 companies and 4,000 non-business signatories based in over 160 countries, and more than 80 Local Networks.

More information: www.unglobalcompact.org

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