Principles for Responsible Investment

PRI

Responsible investment in private equity

A guide for limited partners

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About the Principles for Responsible Investment

The UN-backed Principles for Responsible Investment (PRI) is a framework to help investors build environmental, social and corporate governance (ESG) issues into their investment process, to improve long-term returns and create more sustainable markets. The Principles were developed by, and for, pension funds and investment managers.

The six Principles are:

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.**

While all PRI signatories commit to applying the Principles across all asset classes, individual signatories decide how best to apply the Principles to their investment activity. Our 2011 survey showed that 94% of PRI signatories have developed their own responsible investment policy.

Where necessary, the PRI Secretariat convenes expert groups to consider how to support signatories' continuous improvement in implementing the Principles. Since March 2008, PRI has operated a formal work stream on private equity.

For more information see **www.unpri.org/privateequity**.

The PRI Initiative has over 850 signatories made up of financial institutions from 48 countries with approximately US$ 25 trillion of assets under management.

The Principles themselves, a full list of signatories and more information can be found at **www.unpri.org**.

About this guide

Consistent with the PRI Principles on which it is based, this guide is aspirational. It outlines how limited partners (LPs), general partners (GPs) and portfolio companies each have a role in promoting better and more consistent integration of ESG factors into private equity investment decisions.[1]

The target audience is any LP seeking to ensure that their GPs work with the underlying portfolio companies to consistently and effectively identify and manage material ESG risks and opportunities, with the aim of improving long-term, risk-adjusted returns. It can help an LP fulfil its fiduciary duty to beneficiaries, and ensure that its GPs fulfil their own fiduciary responsibilities

This guidance applies to any private equity investments, including: venture capital, growth, 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 fund structure, such as infrastructure and real estate.

The document is divided into three sections:

1. **An overview**, which describes some key characteristics of private equity to consider when developing and implementing an ESG policy.

2. **Substantive guidance** for how an LP might integrate ESG considerations into:
   - investment policy and investment decisions (PRI Principle 1)
   - ownership activities, i.e. monitoring and engagement (PRI Principle 2)
   - the disclosures sought from a GP and underlying portfolio companies (PRI Principle 3)

3. **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.

This guide is not intended as a checklist. It is a starting point for an LP who wants to develop its own approaches to responsible investment in private equity. This guide does not advocate altering a GP's management role and discretion over decision-making. It does not imply that new channels are necessarily required for the disclosure of ESG-related information. While it can help an LP to effectively implement exclusion policies, this guide does not suggest that investors need to establish, or encourage others to establish, new exclusion policies.

The following abbreviations are used:

- GP – General partner
- LP – Limited partner
- PRI – Principles for Responsible Investment
- ESG – Environmental, social and corporate governance

This guide was developed and approved by the PRI Private Equity Steering Committee, which is comprised of asset owners, funds of funds and general partners. Involving both LPs and GPs in developing this guide shows the aligned interests both parties have in addressing ESG issues in private equity more effectively. See page 26 for information on the **Steering Committee members**.

1. This guide refers to private equity funds as limited partnerships and uses terms such as LP, GP and limited partnership. However, in practice, a private equity fund may take other legal forms such as a limited liability company.

Overview of responsible investment and private equity

Responsible investment describes an investment approach that integrates ESG factors into investment decisions and ownership activities.[2] PRI signatories believe there are benefits to long-term, risk-adjusted returns if capital is invested and managed when considering short and long-term risks and opportunities. Asset managers that do not integrate ESG factors are not fully aligned with the interests of their PRI signatory clients.

Investors at all stages of the investment chain have a fiduciary role in helping to steward the assets in which their capital is invested. It is in this context that PRI signatories identify and manage the risks and opportunities that may arise from ESG factors, noting that these may differ across companies, sectors, asset classes and through time.

IMPACT OF ESG FACTORS ON COMPANIES

ESG factors can impact on both publicly and privately owned companies in the following ways:

- Capital and operating expenditure
- Liabilities and associated balance sheet implications
- Operational disruption
- Competitive position
- Cash flow forecasts
- Legal compliance
- Access to capital
- Management controls
- Demand for goods/services
- Reputation/brand

While ownership structures and governance differ between public and private equity, the underlying asset in which they invest is the same – a company. The information and analysis needed to identify and manage material ESG risks and opportunities is the same in public and private equity. Any institutional investor that has integrated ESG into its public equities has the skills to do so in private equity as well. And while LPs have not traditionally asked GPs for ESG-related information on portfolio companies, such information may be available on request, or the GP may be willing to collect it over time.

GOVERNANCE CHALLENGES

Private equity has a long-term investment horizon, with the GP bridging the gap between company management and its beneficial owners. At its best, private equity is a stewardship-based style of investment and should benefit from increased focus on ESG issues. Responsible investment should be seen as a natural step for private equity investors.

However, an LP should inform itself of the differences between public and private equity. One key difference is the role of the GP and the different governance challenges this creates. Private equity does not face the governance challenges that largely define investors' work on responsible investment in public equities (i.e. aligning the interests of company managers and a diverse pool of shareholders).

2. Throughout this guide, the term "responsible investment" and "ESG integration" are used synonymously to mean "the integration of ESG factors into investment decisions and ownership activities". The PRI Principles are included on page 2.

However, the industry still faces a governance challenge: how to align the interests of asset managers (GPs) with a diverse pool of capital providers (LPs).

Just as investors have advocated changes to corporate governance and disclosure practices to be able to more effectively act as stewards of publicly-owned companies, so too must an LP consider fund governance and disclosure practices to act effectively as a steward in private equity. An LP is encouraged to seek guidance on private equity fund governance best practice from the Institutional Limited Partners Association's (ILPA) Private Equity Principles 2.0.

CHARACTERISTICS OF PRIVATE EQUITY WITH IMPLICATIONS FOR ESG INTEGRATION

The key characteristics of private equity that should inform an LP's approach to integrating ESG factors are:

- **Private equity funds are normally structured as limited partnerships**. These limited partnerships are managed by a GP, who is responsible for sourcing and analysing investments, executing investment decisions, monitoring and advising the fund's investments, and eventually selling portfolio companies. An LP provides capital to the limited partnership.
- **Private equity fund investments are long-term**, with an LP typically committing capital for 10-15 years. Capital is invested during an investment period that may last five years or more, with the remaining life of the fund spent disposing of investments and winding down the fund.
- **Private equity is a buy-to-sell model**, not buy-to-own. The average holding period for a portfolio company is 3-7 years, and all investments must be sold within the life of the fund.
- **Investing in a fund generally involves a blind pool commitment**. While an LP commits capital to a fund with a defined investment strategy (typically including geographic, sector and company size restrictions), the underlying assets (portfolio companies) are not known until after the fund is operational. Therefore, an LP's investment decisions are based significantly on the nature of the fund's investment mandate, the GP's track record, and the LP's assessment of the fund terms, conditions and governance to ensure an alignment of interest between the LP and GP.
- **Private equity investments are relatively illiquid**. Although the secondary market has matured in recent years, an LP cannot easily sell its interests, and such sales generally require permission from the GP. In addition, changes to the investment mandate may require negotiating with other fund investors.
- **GPs have complete discretion over investment decision-making and ownership activities** for both legal and practical reasons. An LP typically invests in funds on the basis of a GP's ability and judgement, and therefore delegates managerial functions to a GP. While a GP may obtain an LP's input on various issues relating to a fund, an LP that provides input beyond being consultative in nature may undermine its limited liability status, depending on the jurisdiction and the particular facts involved.
- While an LP cannot make, or materially influence, specific investment decisions, **a distinction can be made between influencing a decision and influencing a decision-making process**. As a result, in dispatching its fiduciary duties, an LP should monitor and, where necessary, engage a GP about the policies, systems and resources used to identify, assess and make investment decisions, including ESG risk management.

- Communication between GPs and LPs. There are four main channels a GP uses to communicate, or engage with, its LPs:
  - i. **Limited partner advisory committee (LPAC)**: The LPAC is generally comprised of the largest LPs in a fund, who represent their own interests. LPAC practice and mandate differs widely between funds, but often includes consents or waivers with respect to transactions involving conflicts of interest, valuation policies, investment period extensions, and other issues on which a GP seeks LP input. If LPAC members have a commitment to, and a competence in, ESG integration, it may be an effective body for addressing ESG integration.
  - ii. **Annual general meeting (AGM)**: During the AGM, a GP generally reports on fund investment and performance during the previous year to all LPs. AGM practice differs across funds, but is generally for sharing information and not for seeking formal input on decisions.
  - iii. **Periodic GP reports**: The frequency and content of a GP's reporting obligations is generally set in the fund's governing documents. ILPA has developed standardised reporting templates, which an LP may consider when defining its expectations. An LP with specific reporting requirements will sometimes seek additional commitments from the GP in a side letter.
  - iv. **Meetings**: GPs and LPs may arrange telephone or in-person meetings. Unless otherwise stated in a fund's governing documents, such meetings take place at a GP's discretion.
- **GPs generally make large investments in a relatively small number of companies**. The concentration risk associated with this investment style may be mitigated by a number of factors, including:
  - the amount of due diligence undertaken by a GP before investing in a company
  - a GP's complete access to full management accounts of a portfolio company, both before and after investment
  - a GP's significant influence or control over a company after an investment has been made, which could include board representation, access to management, ability to add or replace management, or the timing of an exit.
- **GPs generally seek a degree of influence over their portfolio companies**. In the case of buyouts, GPs frequently purchase a full or majority stake in the portfolio company. In other cases, even with a minority investment, the GP may nominate one or more board members. This allows GPs to exert influence both as a significant equity investor and through their board representative(s), as company director (gaining influence over corporate strategy, governance and senior management).
- **The private equity ownership and governance model is based on the close alignment of LP, GP and portfolio company management interests**. This increases investors' ability to influence how ESG issues are addressed within portfolio companies.
- **LPs within a fund are likely to differ in their approach to responsible investing**. LPs that engage with GPs on ESG issues may not necessarily have the support of other LPs that may have a different perception of whether or how ESG factors can impact risk-adjusted returns.

- **GPs generally have full access to management accounts within their portfolio companies**. As a result, while portfolio company reports often include less information than those of publicly listed companies, significant additional information is likely to be available upon request. This may include information on strategy, risk management and key performance indicators (KPIs).

CHARACTERISTICS OF PARTICULAR FORMS OF PRIVATE EQUITY

Funds of funds

Many institutional investors choose to invest in private equity through a fund of funds. Funds of funds manage the relationship with GPs on behalf of several LPs. Funds of funds often have better resources and are more experienced at investing in private equity, and therefore have the potential to more effectively oversee and influence a GP's approach to ESG integration. However, unless a fund of funds is running a managed account, it must adopt an investment strategy that serves all LP interests. Funds of funds may find it difficult to give a level of attention to ESG factors that some LPs believe is consistent with fiduciary duty if only a minority of LPs express an interest in ESG integration.

Co-investments

Many institutional investors seek more direct exposure through co-investments, where they invest alongside a GP in a specific portfolio company. Co-investors are usually an LP in the fund from which the GP makes the portfolio company investment. A co-investment may give an LP the opportunity to participate directly in the due diligence process. Depending on the relative size of the stake, a co-investor may also have the right to appoint a board member. The co-investor's role may require different types of expertise and internal resources. In comparison with other LPs, co-investors may have more and better access to portfolio company information. Co-investments may also provide investors with opportunities for more detailed assessment of ESG-related risks and opportunities, both before investing and throughout ownership.

Secondary investments

Unlike primary fund investments, where capital is being committed to a blind pool, a secondary investment involves the purchase of an LP's position, either in an existing fund (secondary fund investment) or in specific private companies (secondary direct investments). Secondary investments provide a selling LP with liquidity and the opportunity to rebalance its portfolio. ESG due diligence can in theory be undertaken on underlying portfolio companies prior to investment because, unlike a primary fund investment, the portfolio is known. However, these transactions generally do not give an LP the opportunity to renegotiate existing documentation to include any ESG issues.

Emerging markets

As more LPs commit to emerging market private equity funds, an LP should consider factors that may differ from developed market strategies, including:

- 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. Many legal processes may take longer in emerging markets, which often means that enforcement actions may stretch beyond the terms of the fund itself.
- There may also be differences in the regulatory regimes for a variety of ESG factors. As a result, additional legal compliance may be required, and legal compliance is not always a sufficient baseline for performance expectations.

While emerging markets may have risks not common in developed markets, GPs investing in emerging markets may also have more experience with ESG factors. Development finance institutions play an important role in the emerging market LP community. They have used detailed ESG-related performance requirements and been engaging with GPs on ESG factors for several years.

Guidance for Limited Partners

GENERAL CONSIDERATIONS

The effectiveness of an LP's investment decision-making and responsible investment policy will depend on a range of internal and external parties. For example, because a GP must act in multiple LP interests, an effective ESG approach may depend on its consistency with the expectations of other LPs.

1. An LP should develop a policy statement (and related implementation tools) that defines its approach to responsible investment in private equity. The policy statement should include:
   - The LP's expectations of its GPs (noting that expectations could differ based on the size of a GP or the nature of their activity)
   - factors the LP includes within the scope of ESG issues
   - where relevant, an indication of which specific ESG factors are a priority.
2. An LP could share their RI policy and implementation tools with other LPs and GPs, and consider making them available publicly.[3]
3. An LP could seek input on its ESG policies from other LPs, GPs, investment consultants, and in-house teams with experience integrating ESG issues in public equities and private markets.
4. An LP could review ESG policies used by GPs and other LPs and, wherever possible, make efforts to promote compatibility, particularly with respect to due diligence questionnaires, relevant terms in limited partnership agreements or side letters, and reporting requirements. See **Additional resources** for sample questions and side letters that can help promote more consistent approaches to ESG integration.
5. An LP could ensure that staff, consultants, service providers, intermediaries and GPs are aware of their approach to responsible investment, and obtain relevant training and/or have access to sources of expertise.
6. An LP should give due regard to ESG criteria in their internal due diligence and fund selection processes. This may include developing investment analysis criteria or a section in the investment recommendation report assessing a GP's ESG approach.
7. An LP could include ESG criteria in their mandates with intermediaries (such as investment consultants and funds of funds) or service providers acting on their behalf in the fund selection, due diligence or monitoring processes.
8. An LP could determine whether GPs, intermediaries and service providers are able to integrate adequately ESG factors by assessing their policies, systems and/or access to relevant expertise, and/or by reviewing past examples.
9. An LP could encourage a GP to use the LPAC and AGM (or similar fund governance bodies) to provide regular information on ESG integration to seek the LP's input. If the LPAC oversees ESG integration, an LP should ensure that:
   - such a role is consistent with the scope of the LPAC mandate
   - LPAC members have a commitment to, and competence in, ESG integration
   - the minutes of LPAC meetings are accessible to all LPs.

The ILPA Principles 2.0 provide useful guidance on the role and operation of LPACs.

3. The PRI signatory extranet contains examples of ESG policies. LPs are encouraged to use the extranet to share their own policies and tools with private equity investors. More at **extranet.unpri.org**

10. An LP could work with other LPs in the same fund to provide input on a GP's ESG policies and implementation. When acting collaboratively, LPs should respect commercial confidentiality and avoid controlling the decision-making process on issues that lie within the GP's domain.

PRE-INVESTMENT STAGE

An LP is a passive partner in the management of a fund. After an LP has committed capital to a fund, a GP has sole discretion for investment and ownership decisions. Before investing in a fund, an LP should assess the degree to which a GP has the policies, systems and resources needed to integrate ESG considerations into its investment decisions and ownership activities. Prior to investing, an LP should also confirm the ESG-related disclosures that a GP will provide during the life of the fund. An LP should clarify formally its expectations for ESG integration before investment, such as in the investment agreement or side letter, because it may be more difficult for the LP to address its concerns post-investment.

Due diligence

11. An LP should include questions on ESG integration and/or portfolio company risk management in their formal due diligence process. An LP should consider whether the size of a GP or the nature of its activity justifies a different approach to due diligence. See **Additional resources** for sample due diligence questions.

12. An LP could ask GPs whether they have an ESG policy and what it entails, the status of implementation, and how regularly changes to this policy are considered and implemented.

13. An LP could provide a GP with a statement explaining its PRI commitments and responsible investment policy, and request information on how the GP plans to address these commitments within the fund.

14. An LP could ask for examples of how GPs have identified and addressed ESG-related risks and opportunities in past, existing or potential portfolio companies.

15. An LP should assess, even through informal discussions, the GP's understanding of ESG impacts on the financial and non-financial performance of a company, and the GP's commitment to improving its management of ESG issues.

16. An LP should not exclude 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 implement the necessary steps early in the life of the fund. In such cases, recognition by the GP of the importance of ESG issues and/or a formal commitment to meet regularly with the LP to discuss ESG factors should be expected before committing to a fund. The appropriateness of this approach also depends on whether the LP has the capacity to engage actively post-investment to encourage, monitor and/or assist the GP's integration efforts.

17. Since an LP may not have the resources to engage actively with all its GPs, they could use the information obtained during the due diligence process to prioritise which GPs warrant engagement on ESG integration post-investment.

Documentation

18. Before investing in a fund, an LP should ask a GP to describe and, where relevant, make commitments regarding its approach to ESG integration. Where formal documentation is deemed necessary, such commitments could be described in the fund's memorandum and/or included in the fund's governing documents or in a side letter. Guidance on side letters is available in the **Additional resources** section.

19. An LP could seek information and/or commitments on:

- how a GP identifies and addresses ESG factors during the investment, ownership and exit processes
- the resources, including specialist expertise, that a GP anticipates applying to ESG integration
- how a GP intends to implement an LP's responsible investment policy, including, where relevant, any exclusions (e.g. sector or geographic restrictions on investments)
- the scope and frequency of ESG-related information that a GP will disclose during the term of a fund, for instance in:
  - quarterly and/or annual reports on the fund and GP management company
  - quarterly and/or annual reports on the portfolio companies
  - capital calls
  - investment memos.
- whether, and if so how, a GP plans to provide updates on significant or material ESG issues that may arise in a portfolio company, subject to necessary commercial confidentiality
- whether, and if so how, a GP will use the LPAC, the AGM or other channels to seek input from LPs on a GP's approach to ESG integration and/or portfolio company risk management and ESG performance
- right to inspect and/or communicate with certain portfolio companies regarding ESG issues.

POST-INVESTMENT STAGE

Once invested in a fund, an LP generally has only a passive role in ownership activities. Many funds establish an LPAC to enable a GP to engage with LPs, but overall responsibility for decision-making remains with the GP. As a result, an LP should focus on monitoring how a GP integrates ESG issues into its investment decisions and ownership activities, and engaging with a GP on specific areas for improvement or concern. While a GP may be able to provide a broad range of ESG-related information at both fund and portfolio company-level, an LP should only request information that it intends to analyse and utilise, and should recognise that commercially sensitive information may in some instances have to remain confidential. An LP should be prepared to justify the need for additional information and to provide a reasonable timeframe for the GP to respond to such requests.

Monitoring

20. An LP could request information from a GP either formally (such as email, meeting minutes, annual report, fund reports, portfolio company reports) or informally (such as telephone calls, un-minuted meetings). This information may include processes and activities within both a GP and the portfolio companies, and ESG performance within portfolio companies.

21. Where a GP has made a specific ESG integration commitment to an LP, formal or informal reports on progress could be requested. Where formal updates are desired, an LP should, wherever possible, accept the use of existing channels for the communication of these reports.

22. An LP should encourage a GP to report and seek input on its ESG integration approach and ESG-related risks and opportunities within portfolio companies at annual meetings or in the LPAC.

23. An LP could request that a GP develops criteria and procedures for notifying the LP on significant or material ESG-related risks arising during ownership. An LP could encourage a GP to clarify what constitutes "significant or material" through discussion with the LPAC or during annual meetings.

24. In accordance with PRI Principles 3 and 6, an LP should encourage GPs to provide broader disclosure of non-confidential information on ESG-related issues to other stakeholders.

Engagement

25. An LP could engage with a GP, whether formally or informally as appropriate, to highlight the importance of, and approaches to, responsible investment. Wherever possible, engagement should relate specifically to a GP's portfolio of companies.

26. An LP should encourage a GP to develop and improve its own ESG policy and implementation, using the PRI, the UN Global Compact and ESG-related documents produced by private equity associations and others (see **Additional resources**).

27. If the applicable regulatory regime(s) and contractual confidentiality provisions permit, an LP could share ESG-related research, including issue- and sector-based analysis, with its GPs.

28. Where an LP believes that it has identified a material ESG risk or opportunity, the LP could alert the GP, request that a GP address the issue and, where relevant, decide on a course of action. Such course of action could include: seeking additional information, engaging with relevant portfolio companies, and reporting back to the LP.

29. Within legal constraints, an LP within a fund could work collaboratively to provide input to a GP on potential improvements to ESG integration at the fund level and within specific portfolio companies and encourage reporting about such integration.

30. An LP could work with peers and GPs to develop further and improve ESG standards and promote sustainability within the private equity sector.

31. An LP could encourage a GP with which it invests to become a PRI signatory and to participate in the PRI Private Equity Work Stream.

Disclosure

All those within the investment chain should be accountable for the effective application of their fiduciary duties. This applies as much to an LP, who is accountable to their clients and beneficiaries, as it does to GPs and portfolio companies.

Although the confidentiality of commercially sensitive information is paramount, disclosure to an LP and by an LP is necessary for accountability and reporting to beneficiaries. Without relevant ESG disclosure from investment entities, an LP cannot effectively monitor how ESG factors are being addressed and, where necessary, engage to seek improvements in ESG integration. Some guidance on disclosure has already been provided above under "Pre-investment – Due diligence" and "Post-investment – Monitoring". This section outlines more generally the type of information an LP could seek disclosure on, and could themselves disclose to their beneficiaries. Consideration should be given to avoiding unnecessary complexity and volume – in many cases aggregated disclosure may be adequate. Some disclosure could be proactively communicated, while other information may be more appropriate when required or requested.

DISCLOSURE BY LPS

32. Subject to regulatory, contractual and fiduciary duty obligations, an LP should disclose relevant information to the parties to which it is accountable, such as its board of trustees, investment committee, executive committee, clients and beneficiaries.

33. An LP could disclose any responsible investment policy applicable to private equity investments, as well as the tools, systems and resources used to implement and monitor the effectiveness of such policies.

34. Subject to regulatory, contractual and fiduciary duty obligations, an LP could maintain a record of, and/or disclose, whether a GP's approach to ESG integration is aligned with the LP's own policies and effectively implemented. This analysis could be aggregated by categorising GPs into a variety of bands or grades.

35. An LP could maintain a record of information on:
    - material breaches of the LP's ESG policy or the ESG-related terms contained in a side letter
    - ESG-related incidents that could be expected to have a material impact on the company or created headline risks
    - areas for improvement.

36. An LP should seek to integrate ESG-related information into its internal risk reporting, noting that this may be a qualitative assessment.

DISCLOSURE BY GPS

37. Both before and on an ongoing basis after investment, an LP should seek from each GP an assessment of, among other things:

- whether a GP's overall approach to ESG integration is consistent with the LP's interests
- whether a GP has committed appropriate resources to the integration of ESG factors, including both general staff training and specialist expertise
- whether a GP consistently and effectively improves its ESG integration methods
- whether a GP consistently and effectively ensures its portfolio company boards pay appropriate attention to, and have sufficient expertise in, ESG factors
- whether a GP consistently and effectively assesses ESG-related risks and opportunities considered by its portfolio companies
- what the overall ESG risks or opportunities are across a GP's portfolio.

DISCLOSURE BY PORTFOLIO COMPANIES

38. An LP should seek ESG information on underlying portfolio companies to assess how GPs and portfolio companies are effectively identifying and managing material ESG risks and opportunities. This may involve knowing:

- whether the portfolio company integrates ESG factors into strategic planning and risk management
- what material ESG-related risks and opportunities are facing the company
- what policies and procedures the company has put in place to mitigate material risks and to capitalise on material opportunities
- what KPIs the company uses to monitor the success of ESG-related policies and procedures.

39. An LP could explain to its GPs how it uses portfolio company ESG information and the most appropriate form and frequency of disclosure. An LP should collaborate with the GP and other LPs to develop approaches to ESG disclosure that are suitable for all interested LPs.

40. Where a GP discloses only aggregate ESG data or information on selected portfolio companies, an LP could ensure that the GP is also willing to provide, upon request, specific ESG information from any company within the portfolio.

41. Without unnecessarily limiting the scope of disclosure, and wherever possible, an LP's request for ESG-related information should be consistent with the relevant guidance in the ILPA Principles 2.0 and the ILPA annual and quarterly reporting templates.

Additional resources

DUE DILIGENCE AND ENGAGEMENT QUESTIONS

The following lists of questions can help an LP integrate ESG issues into its due diligence processes (pre-investment) and in their ongoing engagement with GPs (post-investment). **They are not intended to be used as a checklist.**

Each LP should develop an approach suited to their investment style and commercial interests. An LP should not ask for information they will not use. However, an LP should consider questions from each of the five headings below – fund mandate, a GP's approach to ESG integration, a GP's approach to ESG during due diligence, a GP's approach to ESG during ownership and exit, and a GP's approach to LP dialogue, disclosure and stakeholder relations. When developing an approach, an LP could draw on their experience of ESG in public equities.

Different funds may have different exposure to ESG-related risks and opportunities, and different GPs may have different capacity to address ESG issues. An LP should therefore consider applying different questions to different GPs. In most cases, an LP should consider asking for genuine examples that show how policy is implemented in practice within specific portfolio companies.

Fund mandate

Before investing in a fund, an LP should assess:

- whether the fund mandate focuses on sustainability-related themes (such as clean technology, education, health)
- whether the fund mandate is consistent with the LP's exclusions policy (for example, investments will not be made in specific sectors or countries)
- whether the fund mandate focuses on sectors or geographies with relatively higher ESG-related risks and opportunities.

Questions could include:

- Does your fund expect to invest in [include sectors relevant for LP ESG policy]? If so, which ESG-related risks and/or opportunities have you identified as being of particular importance in these sectors?
- Does your fund expect to invest in [include geographies relevant for LP ESG policy]? If so, which ESG related risks and/or opportunities have you identified as being of particular importance in these geographies?
- If your fund targets specific sectors, please indicate for each sector whether there are any specific ESG risks or opportunities that you pay particular attention to during the investment analysis and/or due diligence process.
- If your fund targets specific geographies, please list any country and/or region-specific ESG risks or opportunities that you pay particular attention to during the due diligence and/or portfolio review process.
- Does your fund have a formal policy to exclude investments in any sectors or regions, or based on any ESG criteria?

- We have an exclusions policy that currently precludes investments in the following: [insert description of any exclusions policy, where relevant]. Does the scope of your fund mandate include investments that would fall within this scope? If so, would you be willing to ensure that our capital is not used for such investments?
- Our exclusion list is occasionally reviewed and may change during the investment period of the fund. If this happens, would you be willing to consider expanding the range of investments you agree to exclude us from?

A GP's approach to ESG integration

Prior to investing in a fund, an LP should assess whether the GP has a responsible investment policy, systems and processes for identifying and managing ESG-related risks and opportunities during investment decision-making, and ownership activities. After investing in a fund, an LP should continue to review this information to assess whether a GP's policies, systems and processes continue to be applied effectively and are continually improved. It may also be useful to ask if other LPs in a GP's funds have also expressed an interest in ESG factors.

Questions could include:

- Do you have a policy that describes your firm's approach to identifying and managing ESG factors within portfolio companies? If so, please provide a copy. If not, please indicate whether you believe ESG factors can impact returns on investment and whether you would consider adopting a policy.
- If you have a responsible investment policy, how have you communicated your approach to ESG to your LPs, staff and portfolio companies?
- If you have a responsible investment policy, has its adoption brought benefits to your firm, funds, and portfolio companies? Please provide some examples.
- If you have a responsible investment policy, does your firm have a staff member with overall responsibility for the implementation of your responsible investment policy? If you do not have a responsible investment policy, does your firm have a staff member with overall responsibility for portfolio company risk management? In each case, please provide name(s), title(s), and an outline of their responsibilities.
- What internal or external specialists do you use for guidance on ESG-related risks and opportunities? Please indicate the most important specialists for each of the following: environmental, social and corporate governance. For each of the most important specialists, please include a brief description of their most recent guidance.
- Where do you get information on potential ESG-related risks? (e.g. company data, interviews with board or senior executives, benchmarking against peers, sector codes and guidelines, internal ESG specialists, external ESG specialists, and rating agencies).
- Do you provide training, assistance or additional resources to your deal teams and portfolio companies to help them understand ESG factors and/or portfolio company risk management? Please provide examples.

- When undertaking staff performance appraisals, are ESG factors and/or portfolio company risk management integrated into the assessment process from any staff? If so, could this influence employee remuneration either directly or indirectly? Please explain.
- Have you identified any obstacles to implementing your responsible investment policy and/or improving portfolio company risk management across your firm and within your portfolio companies?
- What percentage of the capital in your last fund was committed by LPs who are PRI signatories?
- Have other LPs asked you ESG-related questions? If so, would you be willing to share their contact information?
- Have you included ESG-related commitments in side letters? If so, please provide the relevant text or a description. Would you be willing to sign a side letter with us?

A GP's approach to ESG during due diligence

During a GP's due diligence process material ESG-related risks or opportunities are identified and, where necessary, follow-up actions or mitigation plans are considered. If material ESG risks or opportunities are not identified during the due diligence process, it may be more difficult for the GP to address them post-investment. In addition, if unidentified, a GP will be unable to include covenants related to material ESG risks in the sale and purchase agreement.

Questions could include:

- Describe your process for identifying and evaluating potentially material ESG risks and opportunities during due diligence (i.e. scoping and implementation of the due diligence).
- Describe how you resource this aspect of your investment process (internal resource, external consultants, etc), and does this resource have specific expertise in [insert ESG issue(s) of particular relevance to LP]?
- Please provide examples, if any, from your last fund where a material ESG factor was identified during the due diligence process. Where relevant, please include a description of any follow-up action undertaken.
- Under what circumstances, and through what process, would you consider whether to review and assess a portfolio company's approach to [insert ESG issue(s) of particular relevance to LP]?

A GP's approach to ESG during ownership and exit

The average ownership period for a portfolio company is three to seven years. A lot may change during this time within the company, in the regulatory environment and in the marketplace, which may create ESG-related risks or opportunities that were not material at the time of investment. An LP should therefore assess the degree to which the GP has policies, systems and resources to ensure ESG factors are monitored through the life of the investment.

Questions could include:

- What processes do you have in place for assessing regularly the regulatory compliance of your portfolio companies?
- Please provide due diligence materials that demonstrate how you or your service providers identified and proposed the mitigation of ESG risks and/or opportunities at a prospective or actual portfolio company.
- How do you oversee and assess your portfolio companies' identification and management of ESG factors and/or risk management in general? Which bodies, systems, tools and sources of information do you use in this process? Please provide an example of how you assessed a portfolio company's approach to ESG and/or risk management.
- When assessing the expertise of the senior management team and board of a portfolio company, do you include an assessment of their ESG-related and/or risk management expertise?
- Where possible, do you seek to ensure that the boards of your portfolio companies include relevant ESG factors as a regular board agenda item?
- Do you include risks registers in your standard portfolio company reports (quarterly, annual)? Please provide [insert number] examples of risk registers from current portfolio companies, including [insert number] that include ESG-related risks.
- Please provide [insert number] examples from your last fund where a material ESG factor was identified during the period of ownership that had not been identified during due diligence. Please include a description of any follow-up activity.
- When the performance of your portfolio management team is assessed, are ESG factors and/or portfolio company risk management integrated into the assessment process? Could their management of ESG factors and/or portfolio company risks influence their remuneration, either directly or indirectly? Please explain.
- What processes do you have to assess how ESG factors can impact risk-weighted valuations of portfolio-company and/or funds?
- Do you identify ESG and/or portfolio company risk factors that may arise during the sale of a portfolio company? If so, please outline the systems, tools and resources used. How does this differ based on type of exit (i.e. IPO, trade sale or financial buyer)?
- Under what circumstances do you identify and recommend your portfolio companies consider applying recognised voluntary ESG, sustainability or corporate social responsibility standards and codes of conduct, such as the UN Global Compact or sector-based sustainability guidelines? Please provide examples of when you have considered this and any results.
- If we have questions on a potentially material ESG factor within a portfolio company, how should we communicate this question to you? Should we want, under what conditions can we speak directly to the portfolio company?

A GP's approach to LP dialogue, disclosure and stakeholder relations

An LP should not exclude investment in a GP solely on the basis that, at the time a commitment is being considered, a GP's approach to ESG integration is not fully developed or implemented. In such cases, a decision to proceed with an investment may rely on whether there are formal channels for ongoing disclosure and dialogue on ESG integration. While such channels may be of primary importance for LP-GP relations, an LP may also want to consider the value to the fund of the GP having communication channels through which relations with other stakeholders can be managed. These channels may apply both to the GP and to its portfolio companies. Prior to investing in a fund, an LP should therefore consider what channels for disclosure and dialogue the GP has in place, or will commit to putting in place.

Questions could include:

- Please indicate through which of the following channels you regularly communicate ESG-related information to LPs (where relevant, please provide a copy):
  - capital calls
  - investment memos
  - fund and/or GP management company reporting (please indicate reporting frequency)
  - portfolio company reports (please indicate reporting frequency)
  - Limited Partner Advisory Committee meetings (please indicate whether LPAC minutes are circulated to all LPs)
  - annual general meetings.
- If you do not currently communicate ESG-related information regularly, please indicate which of the above-listed channels you would be prepared to use to communicate ESG-related information in the future.
- Do you have a standard template for portfolio company reporting? If so, does it include ESG factors? Does it include [insert specific ESG issue(s) here]?
- Do you have a procedure for identifying when ESG-related issues (including, for example, headline risks, fatalities, industrial accidents, etc) should be communicated immediately to LPs?
- Do any of your portfolio companies produce publicly available reports that include ESG, sustainability or corporate responsibility information? If so, please provide examples.
- Under what conditions do you believe it is necessary for a portfolio company to communicate or engage directly with external stakeholders on ESG factors? Please provide an example.
- Have you ever engaged with external stakeholders on behalf of, or with, one of your portfolio companies?
- Under what conditions do you believe it is necessary for a GP to engage directly with stakeholders on issues related to a portfolio company? Please provide an example.

SIDE LETTERS

Before investing in a fund, an LP should consider whether a formal commitment on certain aspects of ESG integration is needed from GPs. One way to document a formal commitment is to include terms in a side letter. While rarely the sole focus of a side letter, ESG-related provisions are increasingly being included in side letters. The following provides an overview of the kinds of provisions that have been included in fund documents over the past several years.

This list is by no means comprehensive, and is based on a review of a limited universe of side letters. In addition, while the provisions in some cases were very detailed, only a summary is provided below. No assessment has been made on whether these provisions were effective or could actually be enforced against a GP or a partnership in any given jurisdiction. An LP should give careful thought to what ESG-related side letter provisions, if any, are applicable to it, and should seek advice from independent counsel in negotiating such provisions.

Should an LP wish to include a formal commitment by a GP in a side letter, it would be advisable to brief counsel on the objective of the commitment rather than propose specific language.

Restricted list (or exclusions)

Side letters may reference "restricted lists" that preclude investments in (i) individual securities, (ii) securities associated with certain activities (e.g. cluster munitions) or (iii) securities associated with certain countries.[1]

Provisions in this regard may include:

1. GP agrees not to directly invest or allow a portfolio company to invest in securities on an LP's restricted list.
2. GP agrees to discuss additional restrictions with an LP and potentially add to restricted list.
3. GP agrees to excuse an LP from investing in securities that GP does not add to the restricted list.
4. GP agrees to use commercially reasonable efforts to cure violation of restricted list. If violation is not cured, then an LP may be excused from the investment.
5. GP agrees to use commercially reasonable efforts to avoid investments on the restricted list.
6. GP acknowledges receipt of an LP's restricted list, but such notification does not give rise to additional obligations.
7. If GP proposes an investment in a portfolio company on the restricted list then GP shall notify an LP in the capital call notice and the LP may be excused from the investment without requiring an opinion of counsel.
8. GP to use reasonable efforts to comply with an LP's restricted list and responsible investment policy. GP to provide information, subject to confidentiality provisions, regarding investments that do not comply with investor's restricted list and ESG policy and the investor may be excused from the investment.
9. GP agrees to notify an LP if there is knowledge that an investment is reasonably expected to violate the restricted list or an LP's responsible investment policy. GP agrees to use commercially reasonable efforts to consult with the LP on possible remedies provided that this creates no other GP obligation other than the aforementioned notification requirement.

1. On 29July the PRI Secretariat removed examples of specific activities and countries to exclude. This was to remove the risk that the information was taken to imply that specific sector- or country-based exclusions should be pursued. The change was made as a response to feedback from PRI stakeholders.

ESG due diligence, reporting and monitoring

1. GP generally agrees to use commercially reasonable efforts to address ESG issues, including conducting due diligence and annual monitoring to ensure consistency with ESG standards.
2. GP to provide an LP with regular ESG reports compliant with GP's responsible investment policy. Regular reporting to LPs via quarterly, annual reports (including at portfolio companies) and ad hoc through the LP advisory committee. GP to provide the LP with additional ESG information as reasonably requested.
3. GP acknowledges an LP seeks to monitor its investments with respect to its restricted list and may enquire how GP is integrating ESG issues into investment due diligence.
4. GP will designate a person responsible for ESG compliance within 30 days of the fund's closing date and will make such person available to meet with an LP upon reasonable request.

GP efforts to meet external responsible investment standards

1. GP agrees to use commercially reasonable efforts to take into account the UN Global Compact principles if (i) it fits with GP's duties to the fund; (ii) GP is not prevented from acting in the best interests of the fund, and (iii) GP is not required to adopt responsible investment policy.
2. GP agrees to use reasonable efforts, consistent with its fiduciary obligations and primary obligation to maximize the value of the investments, to encourage those portfolio companies (wherein the fund has a board seat) to employ corporate governance practices consistent with relevant regional guidelines (e.g. the Council of Institutional Investors' Core Policies, General Principles, and Positions); provided the date at which compliance is to be assured can be deferred under certain circumstances.
3. GP shall endeavour not to invest in portfolio companies that (i) deliberately and repeatedly violate national laws and certain ILO conventions, and (ii) manufacture or service armaments or firearms that deliberately fail to comply with the United Nations Global Compact or that are in countries subject to trade embargoes imposed by the UN or EU.

GP acknowledges receipt of an LP's policies

1. GP acknowledges receipt of an LP's responsible investment policy. However, acknowledgement does not give rise to any additional obligation of GP.
2. GP acknowledges an LP's desire to invest with responsible investment considerations in mind and has encouraged GP to consider such desire in connection with review and consideration of investments.
3. GP acknowledges receipt of an LP's outsourcing of public sector jobs policy.

GP compliance with its own responsible investment policy

1. GP shall comply with its internal responsible investment policy.

ESG CODES AND STANDARDS

When developing an approach to responsible investment in private equity, an LP can draw on a broad range of other sources, including:

Private equity-specific guidance documents

- AFIC: Développement Durable et Capital Investissement
- AFIC: Charte des Investisseurs en Capital
- BVCA: Guide to Responsible Investment
- BVCA: Walker Guidelines (on GP and portfolio company reporting)
- EVCA: Corporate Governance Guidelines
- EVCA: Governing Principles
- EVCA: Reporting Guidelines
- IIGCC: A Guide on Climate Change for Private Equity Investors
- ILPA: Private Equity Principles 2.0
- IOSCO: Private Equity Conflicts of Interest
- PEGCC: Guidelines for Responsible Investment
- Development finance institutions (DFIs): a variety of DFIs have ESG policies for their private equity investments

A range of specific ESG policies and tools are available to PRI signatories on the PRI extranet.

UN conventions and initiatives

- UN Global Compact (www.unglobalcompact.org/)
- The Universal Declaration of Human Rights (www.un.org/en/documents/udhr/)
- ILO Declaration on Fundamental Principles and Rights at Work (www.ilo.org/declaration/)
- The Rio Conventions (www.cbd.int/rio/)
- The UN Convention Against Corruption (www.unodc.org/unodc/en/treaties/CAC/index.html)

Other intergovernmental organisations

- OECD Guidelines for Multinational Enterprises (www.oecd.org/daf/investment/guidelines)
- OECD Anti-Bribery Convention (www.oecd.org/daf/nocorruption/convention)
- OECD Principles of Corporate Governance (www.oecd.org/daf/corporateaffairs/principles/text)

International financial institutions

- IFC Performance Standards (www.ifc.org/ifcext/sustainability.nsf/Content/PerformanceStandards)
- Equator Principles (www.equator-principles.com/index.shtml)

A comprehensive list of public and private codes, standards and initiatives that may be applicable to portfolio companies is available in the draft ISO 26000 Guidance on Social Responsibility (tables A.1 and A.2, pages 81-90).

THE SCOPE OF ESG

There is no comprehensive list or method for categorising ESG issues. This section contains a list of issues investors refer to under the heading of "ESG". It is not comprehensive and should not be used in a way that restricts the scope of issues that investors may choose to consider. While some investors may define their own priority ESG issues based on industry sector or geography, the concept of responsible investment implicitly seeks to expand the scope of issues considered in investment decisions.

The failure to identify and manage adequately ESG issues may give rise to a range of different strategic, operational and reputational risks and opportunities. Only in some instances may these risks and opportunities be material. While the assessment of materiality is often subjective, many investors expect the analysis to be undertaken in a formal process and based on tangible data.

Other examples of ESG "lists" can be found at:

- CFA Institute publication Environmental, Social and Governance Factors at Listed Companies: A Manual for Investors
- ISO 26000 (draft standard) Guidance on social responsibility
- Global Reporting Initiative (GRI) Sustainability Reporting Guidelines. GRI has also produced a series of Sector Supplements, which offer more specific guidance on the following industry sectors: Electric utilities, logistics and transportation, mining and metals, tour operators, telecommunications and automotive
- The UN Environment Programme's Industry Report Cards on Environmental and Social Responsibility, which were developed in collaboration with over 45 international business and industry associations.

Examples of ESG issues

Environmental issues

- Air and water pollution
- Biodiversity
- Climate change (including policies to mitigate climate change and the impacts of climate change)
- Deforestation
- Ecosystems services
- Energy efficiency
- Hazardous materials
- Land degradation
- Resource depletion
- Waste management
- Water scarcity

Social issues

- Customer satisfaction
- Data protection and privacy
- Diversity and equal opportunities
- Employee attraction and retention
- Employee engagement
- Government and community relations
- Human capital management (including training and education)
- Human rights
- Indigenous rights
- Labour standards (including freedom of association and collective bargaining, child labour, forced labour, occupational health and safety, living wage)
- Labour-management relations
- Marketing communications
- Product mis-selling
- Product safety and liability
- Supply chain management

Governance issues

- Accounting standards
- Anti-competitive behaviour
- Audit committee structure
- Board composition
- Bribery and corruption
- Business ethics
- Compliance (including fines and other sanctions)
- Executive remuneration
- Lobbying
- Political contributions
- Risk management
- Separation of chairman and CEO
- Stakeholder dialogue
- Succession planning
- Whistleblower schemes

Acknowledgements

The first and second editions of this guide were developed and approved by consensus by the PRI Private Equity Steering Committee, comprising asset owners, funds of funds and general partners.

FIRST EDITION

The first edition of this guide was developed between September 2008 and June 2009 by a steering committee consisting of over 30 representatives from asset owners, funds of funds, private equity houses and industry associations. The steering committee included both PRI signatories and non-signatories, and reported to the PRI Advisory Council. The steering committee was managed by Tom Rotherham, Kan Xi and Jerome Tagger. Its members included:

Actis	Ritu Kumar
AlpInvest Partners	Wim Borgdorff, Maaike van der Schoot
AP2	Carl Rosen
APG	Rob Lake
Blue Wolf Capital Management	Mike Musuraca
CalPERS	Jesus Arguelles
CalSTRS	Margot Wirth
Doughty Hanson	Guy Paisner
EVCA	Javier Echarri, Serge Raicher, Vincent Neate
La Caisse de dépôt et placement du Québec	Pierre Piche, Michel Lefebvre
La Caisse des Dépôts et Consignations	Patricia Jeanjean
New Zealand Superannuation Fund	Anne-Maree O’Connor
Pantheon	Carol Kennedy, Helen Steers
PCG AM	Michelle Davidson
PGGM	Leo Lueb
Robeco	Stefan den Doelder
UN Global Compact	Gavin Power
USS	David Russell
Washington State Investment Board	Liz Mendizabal

Apax Partners; The Blackstone Group; The Carlyle Group; Kohlberg, Kravis Roberts & Co; Silver Lake; TPG; Permira and PEC President Doug Lowenstein also participated, representing the Private Equity Council (whose members also included Apollo Global Management, Bain Capital Partners, Hellman & Friedman, Madison Dearborn Partners, Providence Equity Partners and TPG).

SECOND EDITION

The second edition of this guide was reviewed and revised between January and June 2011. Suggestions for revision were received from a variety of sources, including members of the Steering Committee, formal comments received in a one-month public call for input, and informal comments provided to the PRI Secretariat since initial publication. In addition, efforts have been made to ensure consistency with the relevant parts of the Institutional Limited Partners Association Private Equity Principles 2.0, which define best practice on private equity fund governance including alignment of interests, governance and transparency. Steering Committee members include:

Actis	Ritu Kumar
AlpInvest Partners	Wim Borgdorff, Maaike van der Schoot
Blue Wolf Capital Partners	Haran Narulla
CalPERS	Jesus Arguelles
CBUS	Louise Davidson
Doughty Hanson	Guy Paisner
Hermes Equity Ownership Services	Tom Rotherham, co-chair
KKR	Elizabeth Seeger
Pantheon Ventures	Dushy Sivanithy
USS	David Russell

The PRI Secretariat was represented by Katie Swanston (co-chair) and Jonathan Kellar.

Report editing by Joshua Kendall (PRI Secretariat) and Adam Garfunkel.

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Principles for Responsible Investment

PRI

OUR UN PARTNERS

UN Global Compact

Launched in 2000, the UN Global Compact brings business together with UN agencies, labour, civil society and governments to advance ten universal principles in the areas of human rights, labour, environment and anti-corruption. Through the power of collective action, the Global Compact seeks to mainstream these ten principles in business activities around the world and to catalyze actions in support of broader UN goals. With over 7,700 corporate participants and stakeholders from over 130 countries, it is the world's largest voluntary corporate sustainability initiative.

More information: www.unglobalcompact.org

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique global partnership between UNEP and the private financial sector that works closely with approximately 180 financial institutions to develop and promote linkages between sustainability and financial performance. Through regional activities, a comprehensive work programme, training and research, UNEP FI carries out its mission to identify, promote and realize the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

UNEP Finance Initiative
Innovative financing for sustainability

United Nations Global Compact