Principles for Responsible Investment

INCORPORATING RESPONSIBLE INVESTMENT REQUIREMENTS INTO PRIVATE EQUITY FUND TERMS

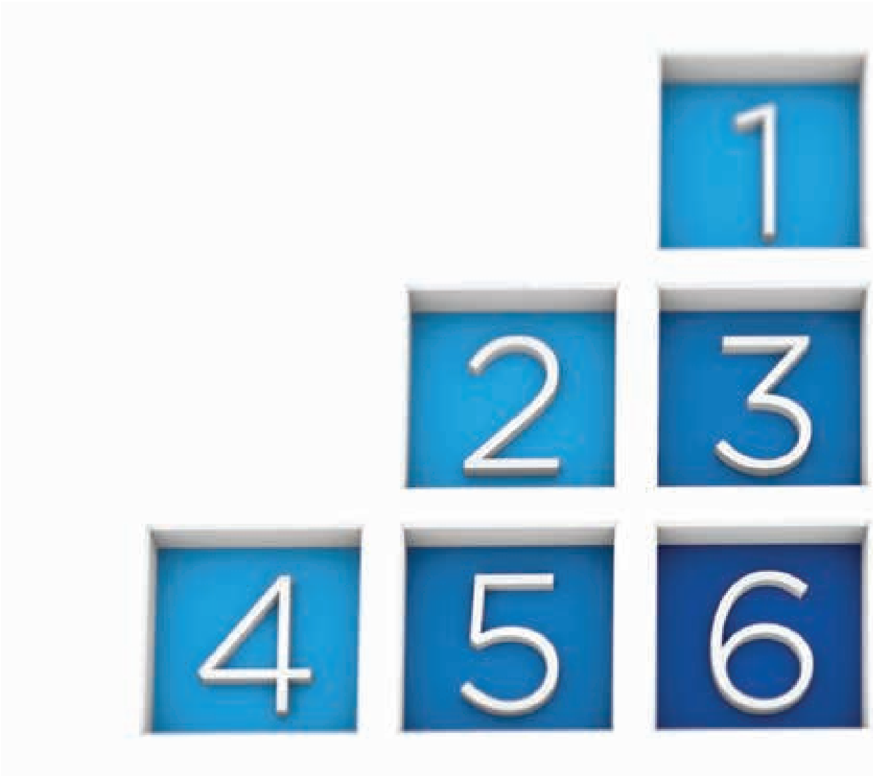
UNEP FINANCE INITIATIVE
United Nations Global Compact
An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

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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- AIC (American Investment Council)
- EMPEA
- ILPA (Institutional Limited Partners Association)
- Invest Europe
- LAVCA (Latin America Private Equity & Venture Capital Association)

WORKING GROUP

The PRI is grateful to signatories on the project working group for their significant input into drafting, reviewing and editing this guidance.

- **APG,** Marta Jankovic, Senior Responsible Investment and Governance Specialist, Head of ESG Integration Alternatives (Co-Chair)
- **HgCapital,** Alison Hampton, formerly Head of Responsible Investment (Co-Chair)
- **bcIMC,** Millie Chow, Senior Principal Infrastructure & Renewable Resources
- **FMO,** Walter van Helvoirt, Environmental & Social Officer, Private Equity
- **Idinvest Partners**, Matthieu Baret, Partner
- **SWEN Capital Partners,** Isabelle Combarel, Managing Director, Head of Business Development & ESG

PROJECT CONTRIBUTORS

The PRI also thanks all those that participated in the project consultation:

- **Advent International,** Andrew Dodge, Vice President, Deputy General Counsel
- **Advent International,** Jarlyth H. Gibson, Risk Officer
- **Adveq,** John Atherton, General Counsel Private Investment Structures
- **Bain Capital,** Bart Gombert, European General Counsel
- **Bain Capital,** Kate Ahern, Director, ESG and Communications
- **Baker McKenzie LLP,** James Burdett, Partner
- **Baker McKenzie LLP,** Victoria Legg, Associate
- **bcIMC,** Britta Wagner, Director, Legal Affairs
- **Campbell Lutyens,** Sarah Dillon, Legal Counsel
- **Davies Ward Phillips & Vineberg LLP,** Sarbjit S. Basra, Partner
- **Doughty Hanson,** Julie Bradshaw, General Counsel & Compliance Officer
- **EBRD,** Anne Maria Cronin, Associate Director, Senior Environmental Adviser
- **EQT,** Therése Lennehag, Head of Responsible Investment
- **Goodwin Procter LLP,** Ed Hall, Partner
- **Hamilton Lane,** Janet Bauman, Managing Director
- **Harvard Management Company,** Michael Cappucci, Senior Vice President - Sustainable Investing
- **Investindustrial,** Alex Browning, Legal Counsel
- **Investindustrial,** Jennifer Flood, Investor Relations
- **Kirkland & Ellis International LLP,** Amala Ejikeme, Partner
- **LGT Capital Partners,** Lionel Cazajus, Executive Director
- **MJ Hudson Law,** Eamon Devlin, Managing Partner
- **Pantheon Ventures (UK) LLP,** John Morgan, Partner, Global Head of Legal & Compliance
- **PGGM Investments,** Jelena Stamenkova van Rumpt, Advisor Responsible Investment
- **Ropes & Gray LLP,** Matthew Judd, Partner
- **Sixth Swedish National Pension Fund,** Jonas Lidholm, General Counsel

CONTENTS

GLOSSARY

ESG – Environmental, social and corporate governance factors
ESMS – ESG management system
GP – General Partner
KPI – Key Performance Indicator
LP – Limited Partner
LPA – Limited Partnership Agreement
LPAC – Limited Partner Advisory Committee
PPM – Private Placement Memorandum

FOREWORDS

The PRI is delighted to share this guidance with the private equity industry, the result of a year-long consultation with PRI signatories, expert counsel and private equity associations. We warmly thank the project contributors, particularly our expert signatory working group, for their guidance throughout this process.

With this, the PRI private equity programme delivers the second in a trilogy of tools designed to support Limited Partners (LPs) and General Partners (GPs) throughout manager selection, appointment and monitoring. Our intention is to drive a more systematic and accountable approach towards responsible investment in private equity. We have experienced an enormous amount of goodwill from both LP and GP signatories, who use the PRI as a platform to work towards an alignment of expectations and to understand best practice as it evolves. The influence this is having on the private equity industry is transformative.

Of course, we are still in the early stages. In this guidance, we note that the incorporation of responsible investment requirements into private equity fund terms is not yet standard practice. However, we anticipate a near future need for comprehensive guidance on this aspect of responsible investment by private equity investors, who rely on the PRI for balanced and pragmatic advice that will encourage reasonable progress and hopefully minimise the duplication of efforts for all concerned. We hope that you find it useful.

Fiona Reynolds,
Managing Director, PRI

There is no doubt that responsible investment is firmly on the agenda for many LPs and GPs, and is increasingly seen as a requirement rather than a differentiator. The private equity industry, with its wide-reaching influence on growth companies across the globe, is well-placed to act as a catalyst for responsible business practices.

This guidance aims to support LPs and GPs as they seek to develop their approaches to responsible investment and formalise their commitment to doing so, be them seasoned proponents looking to refresh their practice or new proponents looking at where to start. We believe in the importance of incorporating environmental, social and governance (ESG) considerations into all stages of the investment process (for both LPs and GPs), and that this is enhanced by creating a robust governance structure, including legal commitments.

We recognise that there are, and could be, many different approaches taken by the variety of players in the industry, and there is no "one-size-fits-all" solution.

It is not our intention that this guidance should be seen as mandating any particular way in which such commitments should be formalised; rather, we have sought to shine a light on current practice in this fast-moving area to enable informed decisions to be taken.

In providing this guidance we see potential benefit to both LPs and GPs so that over time their approach to formally articulating ESG commitments can become more harmonised.

Marta Jankovic,
APG Asset Management, Co-Chair of the PRI working group

Alison Hampton,
HgCapital, Co-Chair of the PRI working group

INTRODUCTION

This document has been developed to help LPs[1] identify options for incorporating responsible investment considerations into fund terms when committing to a private equity fund.[2]

It has also been developed to guide GPs on how they might meet LP expectations on responsible investment when drafting the Limited Partnership Agreement (LPA) and negotiating side letters.

The objective of the drafting and negotiating process as it relates to responsible investment considerations is to articulate the LP's expectations on responsible investment and formalise the GP's commitment to responsible investment, as established during fundraising. This guidance is not intended to be prescriptive, and should be viewed as a resource to assist those LPs and GPs that are considering how to incorporate responsible investment commitments into fund terms.

The 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 a number of important aspects affecting the alignment of interests between the LP and the GP, such as control and governance, conflicts of interest and transparency. As investors have become increasingly sophisticated in their understanding of how responsible investing impacts the quality of their portfolio and returns, and how it might relate to their fiduciary duty or equivalent investor obligations in some jurisdictions[3], many have sought a more formal, structured and binding approach to ensure their own understanding of responsible investment is being upheld. This guidance aims to help LPs and GPs reach a contractual agreement on this point.

LPs that are signatories to the PRI have an annual requirement to report to the PRI[4] on the integration of responsible investment considerations when appointing their private equity managers. Likewise GP signatories to the PRI are asked to report to the PRI on the incorporation of responsible investment considerations in their fund terms. This document aims to support signatories as they comply with this.

Both LPs and GPs will benefit from harmonising their current (and emerging) market practices to articulate and refine ESG-related fund terms. By moving towards greater consistency with their responsible investment requirements, LPs should expect deeper engagement from GPs.

By formalising their commitments to responsible investment in the first draft of the LPA, GPs can expect a more streamlined drafting and negotiation process with LPs. With this aim in mind, this guidance was developed through extensive collaboration between LPs and GPs, and in consultation with industry partners and expert counsel (please see Acknowledgements).

CASE STUDY ON INVESTOR COLLABORATION: THE DFI INVESTMENT CODE

"Development Finance Institutions (DFIs) have been front runners on the inclusion of ESG requirements in their LPAs. DFIs have historically tended to work on a more isolated basis, mainly because they started investing equity at different times. In the interests of practicality, a dialogue between the DFIs concluded in agreement to collaborate on a harmonised approach on their contractual requirements.

This effort has resulted in the Investment Code which is now used for LPAs by all European DFIs. The Investment Code is typically inserted into the LPA by default, making the ESG requirements mandatory for all funds that the DFI invests in.[5]

The Code's requirements are an exclusion list and a system to incorporate ESG risk management in the fund. The Environmental and Social Management System (ESMS) requirements include the appointment of qualified staff to deal with ESG risks and opportunities, training on the topic and proper ESG reporting. The key to a successful ESMS is that it should be a transparent and light description of how the fund is incorporating ESG risks in its investment process, rather than an onerous and complex set of rules. In order to verify whether the ESMS is a functioning system that does in fact address, mitigate and manage ESG topics in the (intended) investments, the fund is required to engage with the DFI LPs during its initial investments. This gives LPs the opportunity to share knowledge and experience with the fund manager, as well as providing constructive comments during the implementation of the ESMS. It must be said that the role of DFIs is slightly different from the traditional LP role, as they often deal with first-time fund managers and/or GPs in emerging markets."

Walter van Helvoirt, Environmental and Social Officer – Private Equity, FMO

1 The guidance is aimed at institutional Limited Partners. Not all LPs have fiduciary or other duties to third parties.

2 The guidance may also be applicable to other types of private institutional funds. Similar considerations may apply to arrangements for co-investment or separately managed accounts which require a separate legal agreement.

3 Please see PRI report Fiduciary Duty in the 21st Century, 2015. The report concludes that failing to integrate long-term value drivers, including ESG issues, in investment practice is a failure of fiduciary duty. To clarify for the context of this guidance, the concept is that an institutional LP has a fiduciary duty to its investors/beneficiaries, and the GP has a fiduciary duty to its LPs.

4 See information on PRI reporting requirements at www.unpri.org/report.

5 The Investment Code is publicly available at www.fmo.nl/products-and-services.

SECTION 1: THE ROLE OF ESG PROVISIONS IN FUND TERMS

WHY DO LPS REQUEST ESG PROVISIONS IN FUND TERMS?

- Formally commits the GP to responsible policies and processes throughout the life of the fund.
- Assists systematic uptake of ESG integration processes by the GP.

Given the length of the investment period and the illiquidity of its investment position, the LP will be particularly concerned with gaining assurance and protection on the management of ESG issues in its investments throughout the life of the fund.

DUE DILIGENCE AND ITS IMPLICATIONS

Before committing to a fund, most LPs assess the GP's performance history, legal terms, governance structure, and market and operational risks. Incorporating ESG due diligence should be part of every LP's responsible investing process. By integrating ESG-related due diligence into its manager selection processes, the LP aims to achieve the following:

- Establish clear expectations and an alignment of investment strategy with the GP;
- Demonstrate the weight of its approach to responsible investment;
- Gain assurance of the GP's ESG risk mitigation processes;
- Understand any reputational risks to the LP and its beneficiaries' interests on specific ESG issues; and
- Make better investment decisions and enhance investment value consistent with its fiduciary duties or investor obligations, where applicable.

The PRI, in consultation with its signatories and industry association partners, has published the *PRI Limited Partners' Responsible Investment Due Diligence Questionnaire* and accompanying guidance And *How To Use It* as the industry standard for LP ESG-related due diligence. It contains an adaptable list of questions designed to enhance LP-GP dialogue on responsible investment and streamline the reporting burden placed on GPs. The GP may have also defined its approach to responsible investment through its Private Placement Memorandum (PPM).

Therefore, when it comes to commitment, the LP should already have a clear idea of the GP's approach or intentions towards responsible investment which may determine the emphasis placed on ESG provisions in the negotiations on the fund terms. Likewise, the GP should hopefully have a clear understanding of the LP's expectations and will anticipate the importance that the LP will place on ESG provisions in the negotiations.

> "At Adveq we have established a responsible investing due diligence framework for evaluating prospective fund investments. We use this framework to assess a manager's adoption of ESG principles, which is important to us as an organisation. The outcome of this assessment then frames our investment decision-making, as well as the negotiation of formal ESG terms and conditions in the legal documents and our responsible investing expectations of the manager going forward."
>
> John Atherton, General Counsel Private Investment Structures, Adveq

INCORPORATING ESG PROVISIONS IN FUND TERMS

GPs have discretion over investment decision-making and ownership activities (usually within pre-agreed investment criteria) for both legal and practical reasons. An LP typically invests in funds on the basis of a GP's ability and judgement, and an LP that contributes to the management of the fund beyond being consultative in nature may undermine its limited liability status. However, an LP will want to understand how investment decisions are going to be made during the lifetime of the fund and to place some parameters around how its capital can be invested.[6] The objective of ESG-related provisions in fund terms is to formalise these parameters with the GP and give the LP greater transparency on the operations of the fund.

6 Responsible investment in private equity: A guide for limited partners, PRI, June 2011

"With regard to our clients, we believe there is a direct correlation between responsible investing and performance, and we work closely with our clients to ensure that their own responsible investment requirements and policies are met as we build their private markets portfolios.

"On the GP side, we routinely incorporate ESG-related questions into our overall due diligence questionnaire to analyse responses alongside every other part of an investment opportunity. In addition to the potential benefit of incorporating ESG provisions proactively, there is also major risk to those managers that ignore ESG. So while ESG provisions perhaps used to be seen as burdens to investors, today they are increasingly being seen as a positive that can help mitigate risk."

Janet Bauman, Managing Director – Fund Investment Team, Hamilton Lane

Ideally, the GP would have a responsible investment policy prepared before fundraising and would have considered how this policy could be appropriately reflected in the fund terms. If a GP does not refer to responsible investment principles, considerations or processes in the first draft of the LPA, the PPM or as part of its due diligence materials, it will be up to the LP to raise the issue with the GP before committing to the fund.

Whether or not the first draft of the LPA contains any ESG-related language, the LP will review the document and negotiate ESG-related provisions with the GP based on its own ESG expectations of its managers and in alignment with its own responsible investment policy. It is important that LPs identify these expectations as early as possible. See Section 3 for an overview of how LPs can formulate their responsible investment expectations of managers in the fund terms.

The process of negotiating with the GP can often result in either the LPA being amended or the GP granting specific ESG provisions in a side letter to that particular LP before its admittance to the fund.[7] See Section 2 for a discussion on the placement of ESG provisions in the LPA versus a side letter.

CONSIDERATIONS FOR THE LIMITED PARTNER

- When developing its due diligence process, the LP would benefit from deciding whether it is conducting responsible investment due diligence for the purpose of assessment or engagement, and to what degree.
  - If assessment, the LP may seek assurance on the GP's commitment to responsible investment before committing to the fund. The LP might use the drafting and negotiating process for the fund terms to formalise this understanding.
  - If engagement, the LP will not necessarily 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 to address the LP's responsible investment requirements early in the life for the fund. In such cases, the LP might use the drafting and negotiating process for the fund terms to request a formal commitment from the GP to responsible investment.
  - It may be that the LP has previously invested with the GP and is confident that the GP has embedded ESG processes that are delivering value to its underlying investments. However the LP may still request ESG-related provisions in the fund terms so that the GP can reinforce its commitment to responsible investment.
- When reviewing the LPA, the LP may tailor its ESG-related requirements for a particular fund based on the size and investment strategy of the GP, and the maturity of its approach to responsible investment.
  - The ability of the GP to deliver on more bespoke or detailed requirements could be taken into account when making such requests.

7 DFI investors have collaborated on an Investment Code as a standard used by DFIs to lay out ESG requirements in the fund terms. An overview is available in the Introduction section of this guidance.

- Conversely the GP might bear in mind that LPs sometimes do not have much flexibility to change ESG requests due to broader institutional requirements.
- It may be that the GP has provided language on its commitment to responsible investment in the first draft of the LPA. The LP then has the opportunity to decide whether this is sufficient for its own requirements before reverting with any mark-up in the negotiating process.

"Since we truly believe that the integration of ESG issues into investment evaluation and governance is an important part of the value creation in any investment, the approach of a GP to responsible investment is always part of our due diligence ahead of committing to a fund. This is in order to ensure that the GP has reached a sufficient maturity and, even more importantly, has an ambition to continuously evolve in that area.

"To us, the willingness of the GP to include appropriate ESG provisions in side letters or, preferably, in the LPA is an indication of the GP's comfort in its internal ESG processes and an important statement of the GP's intent going forward in what we normally expect to be a long-lasting business relationship."

Jonas Lidholm, General Counsel, Sixth Swedish National Pension Fund (AP6)

CURRENT MARKET PRACTICE AND CONSTRAINTS

Before elaborating in the next two sections on how to incorporate ESG provisions into fund terms, it is important to put this guidance in context. This is not yet standard practice, even for PRI signatories that are considered to be industry-leading. The 2017 PRI reporting data, based on submissions from 219 LPs and 332 GPs on their responsible investment progress, indicates (i) that 63% of PRI LP signatories consider responsible investment in their appointment of private equity managers, whereas (ii) 39% of PRI GP signatories are not making commitments to responsible investment in their fund terms, or are not being asked to do so by investors.[8]

"Whilst many sponsors have taken significant steps in recent years to integrate ESG considerations into their investment processes, the perception of a number of investors is that, in general, they are only prepared to enter into relevant contractual undertakings in vague terms during the negotiation of fund commitments. This often results in individual investors requesting agreement to their own particular ESG provisions (sometimes verbatim), which is challenging for sponsors.

"Achievement of a critical mass of support on both the sponsor and investor side for an independent, principles-based and proportionate ESG framework would be helpful in moving the conversation forwards."

Amala Ejikeme, Partner, Kirkland & Ellis

8 See information on PRI reporting requirements at www.unpri.org/report.

This corresponds with findings from the *2017 ESG Research Report* by MJ Hudson and Allenbridge, which notes low levels of ESG references in the latest LPAs and PPMs according to the data held by the LP Unit MJ Hudson. The research identifies a link between the quality and maturity of a GP's publicly available responsible investment policy and the probability of a reference to ESG in its PPM and/or LPA. Furthermore, ESG references are more commonly found in the PPM rather than the LPA, suggesting that the former is easier for GPs to facilitate (as the PPM is not a legally-binding agreement in the same way as the LPA). Interestingly, not all GPs with reference to ESG factors in the LPA will have made similar references in their PPM.

On the investor side, the research report finds a surprisingly high proportion of investors that do not make ESG requests through side letters. Equally surprisingly, it also notes that most of the LPs analysed do not make use of the most favoured nation (MFN) process to elect ESG provisions that have been negotiated by their fellow investors in the fund, thereby missing the opportunity to strengthen their ESG impact.

> "There is currently little contractual footing for LPs, suggesting that ESG integration in private equity funds remains an aspirational endeavour. Our prediction is that the picture will look very different in as little as five years' time and that ESG policies will be front and centre in LPAs."
>
> Eamon Devlin, Managing Partner, MJ Hudson Law

The mandating of responsible investment activity through fund terms may therefore be understood as a fairly recent and relatively advanced practice, and not yet widely used within the global LP community. Although this guidance has been developed with this in mind, it anticipates a near future need for comprehensive guidance on this aspect of responsible investment in private equity. As LP and GP recognition of the role of ESG integration evolves, there is growing appetite to understand how fund terms can be adapted to reflect this.

A wider uptake is however impeded by the following typical constraints or arguments:

- The level of responsible investment incorporation in fund terms will often be influenced by the capacity and relevant experience of the GP and, to some extent, the size and strategy of the fund, as well as the position taken on responsible investment in previous funds.
- The realities of negotiating a competitive fund situation can make it difficult to properly prioritise ESG-related provisions. Clear communication is needed across all members of the negotiating team to ensure that the LP's aims are reflected in the ultimate formulation of these provisions.
- ESG integration in private equity is at an early stage of industry implementation and GPs may be reluctant to commit to any policies or processes that may be subject to significant change during the life of the fund. The GP may be concerned that such commitment would reduce the flexibility it has to moderate its ESG policy or reporting practices as market practice adapts over time.
- ESG integration is driven by the commercial nature and goodwill of the LP-GP relationship and some GPs will view contractual obligations on ESG policy or associated reporting commitments as unnecessary.
- Some responsible investment language may be viewed as incompatible with the "legally enforceable" language in the LPA as it can be principle-driven or value-based.

However, as GPs and LPs seek to increase their integration of responsible investment into the ordinary course of operations, both are likely to benefit from establishing clear expectations around ESG considerations within the fund terms. LPs are likely to embrace proactive approaches by GPs that demonstrate that their responsible investment policies are also reflected in fund terms.

> "It is important to move towards more clarity on expectations in relation to responsible investment, and to acknowledge the growing interest that investors have in ESG provisions. Legal advisers can play an instrumental role in guiding clients to seek best practice outcomes."
>
> Matthew Judd, Partner, Ropes & Gray

ESTABLISHING CLEAR EXPECTATIONS

Both parties would benefit from a clear understanding of what they are trying to achieve through the drafting and negotiating process, and why ESG-related provisions are important enough to include in the fund terms. Due to the nature of responsible investment expectations, it can be difficult to achieve language that is easily defined and objective, as opposed to provisions that are purely financial and commercial.

ESG-related provisions should be clearly articulated to ensure both parties understand and agree on the extent of their obligations, whilst retaining an appropriate degree of flexibility to take into account the nature of private equity investing (i.e. to mitigate the risk of an inadvertent breach by a GP). GPs should be comfortable that they can meet these requirements when putting them into legal wording, otherwise they may pose a risk to their business. It is in the interests of both parties to achieve clarity on ESG provisions to ensure they are a meaningful and useful addition to the fund terms.

"As part of our systematic due diligence process, SWEN CP always negotiates ESG provisions through side letters before committing to a fund. In most cases, it is a very constructive negotiation. It can become a lot more challenging when considering oversubscribed funds who will typically delegate negotiations to external counsel. If external counsel is not adequately briefed or is unfamiliar with the LP's responsible investment objectives, their tendency will be homogenise ESG provisions in order to simplify the MFN process.

"A key objective should be to raise awareness on ESG integration and its challenges within the legal sector beyond a few leading firms, so that they are better able to negotiate on behalf of LPs."

Isabelle Combarel, Managing Director, Head of Business Development & ESG, SWEN Capital Partners

SECTION 2: PLACEMENT OF ESG PROVISIONS

PRIVATE PLACEMENT MEMORANDUM

As GPs increasingly recognise their approach to responsible investment to be of value during fundraising, they will likely highlight this within the PPM. The GP may also provide its responses to the *PRI Limited Partners' Due Diligence Questionnaire* in the PPM or fundraising materials in anticipation of its importance to prospective LPs. The advantage of this is that all LPs that consider investing in the fund are aware of the GP's stance on responsible investment early on.

The PPM is a vehicle through which the GP can disclose its approach to responsible investment. The fund terms are a means of documenting the GP's responsibilities, as agreed with the LPs investing in the fund.

The LP should review the GP's PPM and LPA to get a better understanding of the GP's responsible investment commitments (if any) before deciding on the extent of requests for ESG-related provisions in the fund terms that might be considered necessary. The LP should note that the PPM provides more space for explanation and narrative around the GP's approach to responsible investment than does the contractually binding LPA, and that there are reputational implications for the GP if this is not adhered to. Importantly, the PPM provides a form of assurance to the LP as any disclosure is a representation by the GP that may be actionable if false or misleading.

However, the LP will have greater protection as to its responsible investment requirements if there is a contractual relationship (whether set out in the LPA or in a side letter) expressly highlighting the GP's responsibilities. Furthermore, if the LP has specific policy and reporting requirements in addition to what is voluntarily expressed by the GP through the PPM, the LP should, if possible, make these requirements known early during the review and negotiation process for the fund terms.

INCORPORATING RESPONSIBLE INVESTMENT IN THE PPM

As a disclosure document, the PPM is an appropriate place for the GP to disclose its responsible investment policy. The PPM also allows the GP to provide more narrative around its approach to responsible investment than in the fund terms, and to elaborate on the opportunity side of integrating ESG factors into the investment process whereas fund terms are primarily concerned with limiting downside risk.

A GP's PPM may cover the following points:

- The firm's responsible investment policy or any formal disclosures on the topic.
- Organisational accountability, resourcing and capacity for executing the policy.
- Any plans for value protection and enhancement initiatives.
- Any thematic or strategic basis for ESG integration.

When reviewing a PPM, the LP might consider a lack of any language on responsible investment to be a cause for concern.

FUND TERMS: LPA OR SIDE LETTER?

The GP will draw up an LPA for initial review by the investors that are committing to the fund. The LP can then request ESG provisions or provide a mark-up on existing ESG provisions in the LPA. Alternatively, the LP can seek ESG provisions through a side letter.

An LPA or side letter obligation on the GP provides a greater level of contractual certainty and access to a wider range of legal remedies to the LP than statements of intention in the fund's PPM.

ESG-related provisions in the LPA will commit the fund to an ESG policy or ESG-related obligations (which may already be part of the GP's operational and governance framework) from which all investors should be able to benefit and enforce. The advantage to the GP of incorporating ESG-related provisions into the LPA is that it allows the GP to adopt a standardised approach and officially informs all investors in the fund about the extent to which the GP's operations might be influenced by responsible investment considerations. It may also result in a more streamlined drafting and negotiating process, as there may be fewer side letter requests from LPs. The LP will recognise that the GP will be considering the requirements of all LPs when drafting the LPA, and, accordingly, any language is likely to be relatively generic in nature.

A side letter is an agreement entered into by the GP and a specific LP, which clarifies and/or supplements the terms of the fund documentation when applied to that LP. Side letters permit investors with particular ESG-related priorities or bespoke requirements to put more tailored provisions to the GP for bilateral agreement (this can be particularly suitable for ESG reporting provisions which are specific to the LP in question and not applicable to the broader population of LPs committing to the fund).

Furthermore, if the GP needs to renegotiate on these requirements during the lifetime of the fund it will be more expedient to do this with the single LP in question rather than the broader population of LPs committed to the fund.

GPs that have accepted ESG-related provisions through side letters in previous funds might consider re-incorporating some or all of this language upfront in the LPA, if appropriate. Such a step may be perceived as an improvement and a sign of goodwill by LPs. It will also avoid repeated side letter requests for processes that are already in place.

Whilst there are advantages of consistency and transparency in placing a core set of ESG-related provisions - or a statement of core responsible investment principles - in the LPA as opposed to side letters, there is a range of approaches to this in the market. The GP may deem it inappropriate in its case and will instead propose separate side letter agreements with each LP that negotiates successfully for ESG-related provisions in the fund terms.

In any event, GPs may wish to make their side letter provisions relating to ESG available to all interested LPs through the MFN provision found in many LPAs. The provision generally allows each LP to benefit from the side letter provisions negotiated by LPs, although it may only be available to those with the same or greater levels of commitment.

LPA versus side letter

Benefits of the LPA
Full disclosure and transparency to all investors in the fund.
Provision on ESG reporting would mean that all LPs in the fund would receive this, not just the LPs that request it through side letters.
May achieve expediency in reaching general consensus if responsible investment commitments are included in the LPA.
For practicality, may reduce variance of provisions through multiple side letter requests by including core set of ESG-related provisions in the LPA.
The GP may have other investors in the fund that are indifferent, and possibly opposed, to the concept of responsible investment. It is important for all other investors in the fund to know whether the GP is potentially constrained, and how. ESG-related provisions may protect the GP from investors subsequently arguing that adherence to such ESG obligations negatively impacted on the performance of the fund or of specific portfolio investments.

Benefits of the side letter
Subjective or idiosyncratic requests (i.e. from LPs on non-typical excuse, opt-out rights, exclusions or reporting requirements) could be placed in a side letter.
LPs are at different stages regarding ESG integration and it might be difficult to reach a common standard in the LPA.
It is complicated to construct the right opt out provisions for certain ESG-related provisions in the LPA.
LPs committing to the fund after the first close would likely choose to make any tailored requests through a side letter as any amendments to the LPA will then typically require the consent of a majority of the investors.

SECTION 3: OPTIONS FOR ESG PROVISIONS

ESG provisions in fund terms typically fall under four categories (with some overlap):

1. Commitments to ESG policy or standards, and compliance with ESG-specific regulation;
2. Investment restrictions, exclusions or excuse rights;
3. Investment decision-making processes;
4. Providing ESG reporting and incident reporting to investors.

This section presents the options available to LPs when negotiating on any of these provisions, whether through a side letter or as a mark-up to the LPA.

For an example of how ESG provisions might be constructed, see the aforementioned *2017 ESG Research Report* by MJ Hudson and Allenbridge which presents an Investor Toolkit with sample side letter provisions and a five-point grading system for side letters of varying strength.

1. COMMITMENTS TO ESG POLICY OR STANDARDS, AND COMPLIANCE WITH ESG-SPECIFIC REGULATION

Some LPs may require the GP to comply with an external standard (such as the UN Global Compact or the UN Guiding Principles on Business and Human Rights), whilst recognising the possibility that the standard may be subject to change during the life of the fund. One way of addressing this is to refer to standards as they are in place at the time of the original commitment or as they may be amended from time to time.

PRINCIPLES, STANDARDS AND GUIDELINES

This is an explanation of a non-exhaustive selection of principles, standards and guidelines that may be referenced in fund terms. LPs may require adherence of the GP or their underlying portfolio companies to these, or GPs may make reference to them in their responsible investment policy, PPM and/or fund terms.

The UN-supported Principles for Responsible Investment (PRI)
Launched in 2006, 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. Signatories to the Principles publicly acknowledge the relevance of ESG issues of investment performance, and commit to an annual reporting requirement on their progress towards implementing the Principles.

American Investment Council (AIC) Guidelines for Responsible Investing
The AIC has adopted a set of comprehensive responsible investment guidelines and encourages its members and other fund managers to follow them. The Guidelines were developed in 2009 in dialogue with a group of the world's major institutional investors and under the umbrella of the PRI. The Guidelines ask private equity firms to consider environmental, health, safety, labour, governance, and social issues when investing. The purpose of this structure is to improve portfolio company performance while minimising adverse impacts to these measures during the period of ownership. The Guidelines also call for firms to provide timely information to their LPs on these issues to ensure transparency about their activities.

United Nations Global Compact (UNGC)
The UNGC is the world's largest voluntary corporate sustainability initiative. It seeks to align business operations and strategies with 10 universally accepted principles in the areas of human rights, labour, the environment and anti-corruption. It provides a practical framework which GPs could apply to themselves and/or to their portfolio companies to report on sustainability and responsible business practices.

United Nations Guiding Principles on Business and Human Rights (UNGPs)
The UN Guiding Principles constitute the authoritative international reference point for how states should protect, and how companies should respect, human rights. The UNGPs are not mandatory, but clearly define corporate responsibility to respect human rights. The UNGP Reporting Framework can be used by companies to define their responsibilities with respect to human rights. See the *OECD guidance Responsible Business Conduct in the Financial Sector* which incorporates recommendations for investor due diligence in implementing the UNGPs.[9]

IFC Performance Standards
The IFC Performance Standards on Environmental and Social Sustainability are a globally recognised benchmark for environmental and social risk management in the private sector. They define responsibilities for eight performance standards that IFC clients (fund managers) are required to apply, providing guidance on how to identify, manage and mitigate risks and impacts. The CDC *ESG Toolkit for Fund Managers* and the FMO *ESG Risk Management Tool for Private Equity Investment* are designed to support the implementation of the IFC Performance Standards.[10]

For an overview of International Conventions, Recommendations and Guidance, visit the Downloads & Reference Materials section of the CDC ESG Toolkit for Fund Managers.

9 See http://mneguidelines.oecd.org/rbc-financial-sector.htm
10 See http://toolkit.cdcgroup.com and https://www.fmo.nl/estoolkit

The LP may seek assurance that the GP has a long-term commitment to its own responsible investment policy, and to its continual improvement. The GP would want the flexibility to amend its policy as its approach to responsible investment evolves over time. Any plans to make material amendments to the responsible investment policy could be communicated to or agreed upon with the LP. LPs in some instances may want to be consulted on any material evolution of the policy to ensure that it reflects the original investment proposition of the fund. The LP could stipulate that any material amendment to the GP's responsible investment policy should feature on the meeting agenda of the LP Advisory Committee (LPAC) to avoid situations where a policy may be reduced in scope.

The LP should thoroughly examine the strength of the GP's responsible investment policy – a vague policy, or one not anchored in an external responsible investment standard, may prompt a more rigorous provision from the LP. If the GP does not have a responsible investment policy in place already, the LP could request that it implements one.

Through dialogue with the GP, the LP should have an understanding of the degree to which the responsible investment policy is already implemented (for example, in relation to earlier generation funds), and could require relevant updates on the status of, compliance with and enhancements to, the responsible investment policy. What should be well communicated to the GP is that the LP expects appropriate levels of resources to be dedicated to the implementation of and adherence to the responsible investment policy and that the GP should be able to demonstrate internal capacity to deliver this. The LP could examine the GP's responsible investment policy against its own set of responsible investment criteria and seek to address any clear gaps via a side letter if deemed necessary.

ASSESSING A RESPONSIBLE INVESTMENT POLICY

LPs should benefit from a clear idea of what they require from a GP's responsible investment policy to assess if and how it aligns with their own policy and investment beliefs. A GP's responsible investment policy may cover the following points:

- Investment beliefs/motives
- Adherence to external responsible investment standards or principles and compliance with applicable legislation
- Commitment to continuous improvement
- Approach and objectives
- Policy coverage/scope
- Responsibility and resourcing for policy implementation
- Policy compliance
- Process for policy review and improvement, and for reporting
- Thematic focus (if any)

By assessing a responsible investment policy, the LP can seek assurance that the GP has processes in place to identify, analyse and manage material ESG issues, and that there are appropriate ESG incident reporting and mitigation procedures in place.

LPs may wish to see evidence of a GP's internal commitment to upholding ESG standards across its own operations.

2. INVESTMENT RESTRICTIONS AND/OR EXCUSE RIGHTS[11]

The GP may have its own ESG-related investment restrictions, depending on its investment strategy, and these should be disclosed upfront during fundraising and outlined in the LPA. The LP, in line with its own investment strategy, may also require investment restrictions that preclude a fund from investing in (i) individual companies, (ii) companies engaged in certain activities (e.g. cluster munitions) or (iii) securities associated with certain countries. Investment restrictions should be precise and capable of being implemented easily by GPs and understood by all LPs.

When drafting or considering ESG provisions on investment restrictions, the GP will analyse whether these will materially impact the fund's investment strategy. The LP may consider tailoring its investment restrictions according to the investment strategy of the fund. The investment strategy of a fund is decided by the GP and the GP generally will not (and cannot) accept investment restrictions which materially modify the investment strategy of the fund (which is why the LP must do appropriate due diligence on the fund before deciding to commit). If it is not clear whether the LP's investment restrictions might impact the investment strategy of the fund, the investment restriction could be framed as an excuse right (or opt-out right) rather than a fund investment restriction and determined on an investment-by-investment basis.

11 For the purposes of this document, the term exclusion applies to the fund as a whole; the term excuse right applies to a particular LP investing in the fund.

The LP's investment strategy may evolve over time in accordance with institutional views on how its investment universe should be constructed, which may affect its institutional ESG policy on investment restrictions. Moreover some LPs may have a dynamic investment restrictions list of listed companies that they wish to prevent GPs investing in. The LP could request through a side letter that the GP monitors the LP's investment restrictions policy and dynamic restrictions list, as communicated by the LP. However, in these instances the investment restriction should be framed as an excuse right (or opt-out right) rather than an investment restriction as the LP could not retrospectively alter the fund's investment restrictions list and investment decisions on behalf of all LPs. Moreover, if the GP has already drawn down capital from the LP for an investment that is categorised under a "new" investment restriction, the LP must acknowledge that investment restrictions cannot be applied retrospectively.

An excuse right (or opt-out right) can allow an LP to be excused from a particular investment if the investment falls within the restricted categories previously agreed with the GP (distinct from an investment restriction which would prohibit the fund as a whole from making the investment). In such circumstances, the LP should be notified in the capital call notice that the investment may fall under the LP's excuse right, that a drawdown would not be made from that LP and the LP would not be entitled to receive any distributions in respect of that investment.

Excuse rights are a useful mechanism, but can be complicated to execute. Excuse rights should be as explicit as possible to avoid the GP having to second guess the LP on each investment. In a situation where the GP believes an investment falls under the LP's excuse right, the LP is often given a time frame in which to respond to the GP to confirm whether or not they want to be excused from the investment. It should be agreed upfront whether the default position is that if the LP makes no communication they will be excused from the investment or required to participate. The LP will recognise that it may be unfeasible for the GP to grant too many investors different excuse rights.

Finally, the LP may consider whether excuse rights would protect it from the potential reputational repercussions of investing in a fund that invests in securities that it would deems controversial, regardless of whether its capital is drawn down for that investment.

3. INVESTMENT DECISION-MAKING PROCESSES

If the GP's responsible investment policy does not explain how ESG issues will be factored into decision-making processes, the LP may use the fund terms to require that the GP has processes in place to identify risks and opportunities that could affect the performance of investments, without necessarily prohibiting investment in companies where risks are identified.

The GP may prefer to commit to considering ESG issues when making and managing an investment, but leave it open to interpretation as to what these issues might be as they will be specific to the investment. The GP might clarify that ESG issues will be considered in the overall investment decision but that the GP will determine the manageability of risk. The LP may have a good knowledge of the GP's understanding and prioritisation of ESG risk through dialogue before committing to the fund. GPs and LPs should take care when crafting ESG-related provisions for LPAs and side letters to ensure agreement on the legal interpretation of such provisions.[12]

EXAMPLES OF HOW ESG CAN BE FACTORED INTO A GP'S INVESTMENT DECISION-MAKING PROCESSES

- Conducting an ESG assessment of the portfolio company during due diligence;
- Requesting each portfolio company to consider signing the UN Global Compact's 10 Principles or similar;
- Conducting a fund-wide ESG risk/opportunity screen;
- Incorporating follow-up items on ESG risks and opportunities into the 100-day plan/value creation plan;
- Ensuring that material ESG issues are reported to and appropriately acted upon by the board of each portfolio company.

12 LPs that seek a firmer understanding of ESG risks to investments, for example a DFI investor, may employ the IFC Performance Standards in the fund terms. The IFC's Environmental and Social Performance Standards define IFC clients' responsibilities for mapping their environmental and social risks.

4. PROVIDING ESG REPORTING AND INCIDENT REPORTING TO INVESTORS

The GP could be asked, or required, to specify how the LP can expect to receive ESG-related information during the life of the fund – for example in the annual reports of the fund and portfolio companies, the drawdown notices or through a specific reporting format as determined by the LP. The GP should assess its own capacity for delivering on reporting commitments and at what frequency. The GP may negotiate the frequency or the timing of the reporting, once the format has been agreed with the LP.

The GP may also make use of governance structures already in place – such as by including ESG as a regular agenda item at LPAC meetings and/or the Annual General Meeting, which provide a platform for flexible and engaged dialogue between the LPs and the GP. The ILPA Principles 2.0 defines the LPAC as "a sounding board for guidance to the GP and a voice for LPs when appropriate", and its formal duties are determined in the LPA. It would be of benefit to all LPs investing in the fund that the LPAC be used as a forum to understand ESG risks and performance in the portfolio, as with any other business or reputational issues that are material to portfolio performance.

Through regular reporting, the LP might require:

- Updates on any material changes to the GP's responsible investment policy;
- Demonstration of ESG integration in the due diligence process and adherence to the LP's investment restrictions or exclusions list;
- Demonstration of improvements in the GP's processes for managing ESG issues within the fund and portfolio companies;
- Demonstration of portfolio company management of ESG risks and opportunities, and any initiatives taken by portfolio companies;
- Analysis of progress made by portfolio companies, against prior goals or KPIs;
- Analysis of any material ESG risks or opportunities across the portfolio, with the GP's own analysis of these issues and identification of areas for improvement and action plans;
- Summary of any ESG incidents that may have occurred during the reporting period, regardless of whether these had already been reported on an ad hoc basis (see below) and measures taken to address these.

Some LPs will have specific disclosure requirements that they will request through a side letter, perhaps through a specific format. The LP may consider contextualising ESG reporting requirements in relation to the size and investment strategy of the fund.

The ILPA Principles 2.0 stipulate that GP annual reports should include portfolio company and fund information on material risks and how they are managed, including "extra-financial risks, including environmental, social and corporate governance risks, at the fund and portfolio company level".

The *Invest Europe Handbook of Professional Standards*, last updated in 2015 to address current industry issues including responsible investment and transparency, sets out a range of recommendations regarding ESG factors throughout the life of a private equity fund (from the very early stages of fundraising through the investment process to divestment). Regarding fund terms, the Handbook states that fund documents should address "other reports, such as those covering ESG issues or those required to satisfy tax and other regulatory obligations". The *Invest Europe Investor Reporting Guidelines*, which are part of the Handbook, also set out ESG reporting requirements covering inter alia ESG policy and ESG restrictions. For example, they recommend that ESG reporting should ideally be integrated into the annual/quarterly reporting cycle, rather than operating on a separate timeline.

Both LPs and GPs would benefit from a consistent approach to ESG reporting, and the PRI plans to publish guidance to address this topic in 2018.

ESG INCIDENT REPORTING

The LP will appreciate open and honest communication from the GP on incidents that could have serious reputational implications for the LP, and/or serious financial implications for the investment in a timely manner. Furthermore, the LP will seek an understanding of how the incident is being dealt with as a demonstration of the GP's capabilities. For the GP, having a formal process for investigating ESG incidents at portfolio companies will give them greater insight into the company and an opportunity to address root causes.

Any provision relating to ESG incident reporting should be clear as to how a material ESG incident is defined. Once this is clear, the GP may commit to notifying investors within a specific time period as determined by the LP or as soon as reasonably practical – and there should be some consideration of legal restrictions on disclosure and on timing sensitivities. The LP may prefer an annual summary of ESG incidents – and measures taken to address these – over ad-hoc reporting.

For an example of a serious incident reporting template, see the CDC *ESG Toolkit For Fund Managers* (under CDC Templates).

CREDITS

AUTHOR

Natasha Buckley

EDIT

Eliane Chavagnon

DESIGN

Alessandro Boaretto

The Principles for Responsible Investment (PRI) Initiative

he 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

UN 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

United Nations Global Compact