ESG in Private Equity Part 1: UN PRI & Related ESG Reports and Ratings

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Davis Polk is following the development and evolution of environmental, social and governance ("ESG") frameworks by various organizations that are being employed by private equity general partners and limited partners. This article, covering the Principles for Responsible Investment's ESG Guidance for Private Equity trilogy issued in full on June 13, 2018, is the first item in our series. Our next article will describe the related United Nations Global Compact ESG principles and its use and relevance in private equity. Our third article will discuss the United Nations Sustainable Development Goals, seventeen cutting-edge principles which the investment community is beginning to incorporate. We plan to end this series with a wrap-up article that provides practical, user-friendly advice to GPs and LPs on how to address ESG matters during the fundraising, investment and post-investment stage and what's to come on the horizon.

Executive Summary

On June 13, 2018, the Principles for Responsible Investment ("PRI") **released** its **guidance** on monitoring and reporting of ESG issues in private equity fund terms--the third part of a trilogy of tools designed to help private equity limited partners ("LPs") and general partners ("GPs") incorporate responsible investing into their investment practices. Part III was preceded by Part I, PRI's LP Responsible Investing **due diligence questionnaire** **in November 2015**, and Part II, PRI's **guidance** for GPs and LPs on the incorporation of ESG provisions in private equity fund terms in July 2017 (together PRI's "ESG Trilogy").

This memorandum summarizes the key aspects of each part of PRI's ESG Trilogy, highlighting the most salient aspects for both GPs and LPs. It also analyzes the newly released Part III – its potential impact, utility and what is on the horizon for GP/LP monitoring, reporting and dialogue. Monitoring by GPs and the reporting to and dialogue with LPs of the results poses an organizational, administrative and substantive challenge for GPs for many reasons. First, GPs are currently not being asked by all of their LPs for ESG information and thus, many GPs have not yet put in place the governance procedures to respond to the ESG requests of those LPs that do. Second, all GPs face the challenge of eliciting the relevant ESG information from their portfolio companies, which companies are relatively less sophisticated in ESG matters and/or too leanly staffed to establish their own procedures to monitor and report up to their GPs the ESG matters that the GPs need to report to their LPs. Third, GPs face the challenge of varying engagement or reporting requests from their LPs, which generally have their own set of ESG requests and focus areas. Despite these challenges, demand for ESG reporting is predicted to grow and as noted in "Part III" below, we predict ESG-focused third parties and/or LPs will begin to rate GPs on their ESG practices. If these ratings are made widely available, they could have real impacts on capital allocation decisions and/or the public image of affected GPs. PRI's June 2018 ESG Monitoring, Reporting and Dialogue Guidance thus may be helpful in standardizing the currently bespoke requests of LPs and to GPs to create replicable processes to respond proactively to LP ESG reporting or dialogue requests.

PRI Overview – Formation, Principles and Delisting

PRI is an independent organization formed in April 2006 with a membership consisting of institutional investors. PRI was launched as a result of an invitation by then United Nations ("UN") Secretary General

Kofi Annan to the world's largest institutional investors to develop sustainable investment principles.[1] The group of 63 initial signatories[2] has now grown to over 2,000 signatories, comprising 382 asset owners, 1382 investment managers and 242 service providers.[3]

PRI signatories commit to **six** principles which are "voluntary and aspirational" and offer a "menu of possible actions" for incorporating ESG issues into investment practices[4]:

- We will incorporate ESG issues into investment analysis and decision-making processes.
- We will be active owners and incorporate ESG issues into our ownership policies and practices.
- We will seek appropriate disclosure on ESG issues by the entities in which we invest.
- We will promote acceptance and implementation of the principles within the investment industry.
- We will work together to enhance our effectiveness in implementing the principles.
- We will each report on our activities and progress towards implementing the principles.

To increase signatory accountability, PRI implemented the following three minimum requirements in 2016; if these are not met within a two-year period, it will lead to a private and then public "delisting". So far, several hundred signatories have been delisted. Companies could face negative press or reputation harm if they were to be delisted and so these minimum requirements should be considered before signing[5]:

- Investment policy that covers the firm's responsible investment approach, covering >50% AUM.
- Internal/external staff responsible for implementing responsible investment ("RI") policy.
- Senior-level commitment and accountability mechanisms for RI implementation.

PRI's ESG Private Equity Guidance Trilogy

PRI announced the first part of its ESG Trilogy in November 2015, with part two in July 2017 and part three in June 2018.

Part I (November 2015): LP RI Due Diligence Questionnaire

PRI released the first part of its ESG Trilogy nearly three years ago. It consists of a detailed set of sample due diligence questions that LPs can ask GPs in their pre-commitment due diligence to understand how the GPs integrate material ESG factors into their investment practices. Topics covered in the diligence include ESG policies, the GP's processes for identifying and managing ESG-related risks and opportunities, the GP's contribution to its portfolio companies' management of ESG matters and processes for the LP to monitor the fund's compliance with ESG policies and procedures agreed between

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[1] PRI has the support of the UN, but is not a UN organization and is not associated with any government, and therefore has no governmental or quasi-governmental authority or coercive power. However, PRI works in partnership with the UN Global Compact and the UN Environment Programme Finance Initiative. The UN Global Compact is a voluntary policy initiative pursuant to which companies, cities, NGOs and academic institutions pledge to implement sustainability principles and to take steps to advance the UN's goals in areas of human rights, labor, environment and anti-corruption. The UN Environment Programme Finance Initiative is an initiative in which financial institutions adhere to a statement of commitment recognizing the role of the financial services sector to a sustainable economy. The different memberships of these three organizations complement one another, and together approach the issue of a sustainable economy from different angles based on the roles their respective members play in the global economy.

[2] **https://www.unpri.org/Uploads/n/l/l/PRI-Global-growth-2006-2018.xlsx**.

[3] **https://www.unpri.org/directory/**. A list of all PRI signatories can be found at this link.

[4] **PRI Brochure 2016**

[5] **https://www.unpri.org/Uploads/q/t/s/PRI-Minimum-Requirements.pdf**

the LP and GP at the fund commitment stage. The full list of questions is set forth in Appendix A. We believe many PRI LP signatories have adopted many of these questions in their standard questions to GPs. GPs not yet familiar with these questions should review them and consider developing standard form answers ahead of fundraising when the questions will be asked.

Part II (July 2017): Incorporating RI Requirements into PE Fund Term

The second part of the ESG Trilogy released in July 2017 consists of guidance for how ESG provisions may be incorporated in specific fund documentation such as the LPA (including side letters) and PPM. Unlike PRI's 2015 due diligence questionnaire (Part I), which took the approach of providing a menu of ready to use questions, this guidance is more conceptual and does not provide samples of LPA or side letter provisions or PPM disclosure. PRI indicates that with LPA or side letter provisions or PPM disclosure, many different approaches can be taken by players across the industry, and there is no "one size fits all" approach. They further note that as discussed above, any provisions that the LP wishes to include in the LPA would have to be analyzed against and potentially limited in light of considerations on the appropriate role of the GP and the LP in the overall strategy and management of the fund and that these considerations make pre-commitment due diligence even more important. LPs may request the following types of terms:

Category	Terms
GP Commitment to an ESG Policy	The LP may wish that the GP commit to an external ESG investment policy or standard rather than the GP's own. The LP may wish to receive notices of, be consulted on, or have consent rights for any changes to the GP's ESG investment policy or standards.
LP Investment Restrictions or Excuse Rights	The LP may require restrictions that preclude the fund from investing in: ▪ specific companies; ▪ companies engaged in certain specific activities; or ▪ securities associated with certain countries The LP may request in a side letter to the LPA that the GP monitor the LP's ESG investment policy or list of companies in which the LP does not wish to invest and notify the LP of any conflicts so that the LP may exercise their excuse or opt out right.
Investment Decision-Making Processes	The LP may include a provision requiring the GP to identify risks and opportunities that could affect the performance of an investment without necessarily prohibiting investment in companies where risks are identified.
ESG Reporting and Incident Reporting	The LP may require disclosure in pre-existing documentation such as: (i) annual reports of the fund; (ii) annual reports of the portfolio companies; or (iii) drawdown notices or require a specific reporting format tailored to the LP. The format and frequency of reporting will depend on the LP's requirements but will also be influenced by the GP's capacity to deliver the reporting. PRI does not make any suggestions as to frequency or format, indicating these should be decided in negotiations between the LPs and the GP. The LP may require ESG reporting to be incorporated into the fund's governance structure, such as including ESG matters as regular agenda items at the limited partner advisory committee ("LPAC") if any and/or the annual investor meeting ("AIM"). This format would allow open discussion between LPs and GPs

The reporting mechanism may take two forms:

- The LP may require disclosure in pre-existing documentation such as: (i) annual reports of the fund; (ii) annual reports of the portfolio companies; or (iii) drawdown notices or require a specific reporting format tailored to the LP. The format and frequency of reporting will depend on the LP's requirements but will also be influenced by the GP's capacity to deliver the reporting. PRI does not make any suggestions as to frequency or format, indicating these should be decided in negotiations between the LPs and the GP.
- The LP may require ESG reporting to be incorporated into the fund's governance structure, such as including ESG matters as regular agenda items at the limited partner advisory committee ("LPAC") if any and/or the annual investor meeting ("AIM"). This format would allow open discussion between LPs and GPs.

PRI's guidance notes that ESG terms may be incorporated in either the LPA or the side letter, each instrument with its own advantages. The advantages of either are as follows:

In Side Letter	In LPA
Ease of negotiation	Standardize requirements
Could result in fewer commitments/reporting obligations going forward	Streamline process
Doesn't antagonize investors that do not care about ESG matters	Can include prior terms in first draft
Can pull in LP committing to the fund after the first close rather than amending the LPA	If LPs are invoking MFN clauses to get the same benefits
Avoid drafting complicated opt out provisions for certain ESG-related provisions in the LPA	

Part III (June 2018): Reporting and Monitoring and Dialogue

The final part of the ESG Trilogy released on June 13, 2018 consists of guidance on reporting and monitoring of ESG factors by the GP to its LPs during the lifetime of the fund.[6] Like the 2015 due diligence questionnaire (Part I), this guidance provides a menu of ready-to-use questions. However, it is organized in a customizable framework, by disclosure area, in an effort to establish a flexible approach for LPs to structure their monitoring requests and for GPs to report information. Importantly, the guide seeks to support dialogue and exchange of information, with the ultimate goal of keeping LPs informed about both the ESG characteristics of their private equity investments and the RI practices of their investment managers.

PRI describes the following general principles for ESG disclosure[7]:

- Reporting on a whole-fund basis, and reporting information relevant to the specific fund that the LP is invested in.
- Ensuring the boundaries of the reported information are clear and that information is materially relevant.

[6] https://www.unpri.org/news-and-press/pri-and-erm-launch-guidance-on-esg-monitoring-reporting-and-dialogue-in-private-equity/3296.article

[7] https://www.unpri.org/download?ac=4839 at 34.

- Disclosing information that is accurate and credible, balanced and objective, clear and accessible, comparable and consistent, complete, reliable and timely.
- Aligning the ESG reporting with the fund's financial reporting cycle, rather than operating on separate timelines, if possible.
- Allocating responsibilities and oversight for reporting.
- Allowing for differences in firms' ESG maturities and approaches.
- Considering what format and frequency of reporting is needed for different types of disclosures.
- Maintaining LP-GP dialogue on reporting in order to anticipate and communicate any changes in LP reporting requirements.

A two-tier format distinguishes between core disclosures and additional disclosures: core disclosures elicit key information that most LPs can use for monitoring, whereas additional disclosures support a more detailed understanding of the responsible investment performance of the GP. PRI notes that not all funds may be able to report against core disclosures (particularly first-time funds), but in discussions with the GPs, LPs may be able to set targets to be achieved in the lifetime of the fund. With regard to additional disclosures, PRI holds that not all LPs will have the ability or desire to process the higher quantity of information, particularly if core disclosures prove satisfactory. Similarly, GPs may not have the resources to compile such data.

The PRI Monitoring, Reporting and Dialogue Guidance suggests the following core disclosures from GPs:

I. Policy, People and Process	II. Portfolio Investments	III. Material ESG Incidents
Update GP's responsible investment policy/guidelines/ strategy	Describe ESG risk and opportunity profile of each company	Immediate notification of material ESG incidents
Disclose changes to how responsible investment is resourced and structured at GP	Describe changes to the above based on emerging ESG issues	Periodic summary of material ESG incidents
Disclose how firm manages the ESG aspects of its own operations	How do the portfolio companies manage ESG factors	

GPs should expect LPs to begin specifically asking for these commitments at fundraise and in side letters to the PPM if they have not already.

What Is on the Horizon for ESG Monitoring of GPs?

The PRI Guidance notes some emerging software solutions that will raise the bar for GP disclosure by making it much easier for LPs to monitor such disclosure. The various third party raters of public companies upon which their investors rely may be a precursor to what may occur in the private equity sector. These solutions, however, are only as useful as the quality of the data upon which they rely. GPs thus should scrutinize carefully the veracity and completeness of their disclosures with the view that these and other software solutions will be capturing them. The novel software solutions include:

Monitoring/Reporting Software	Brief Description
ClearlySo Atlas	Helps investors assess the social and environmental impact of their venture capital and PE investments. ClearlySo ATLAS analyzes investment companies and provides actionable recommendations for identified risks and opportunities relating to social and environmental issues. Analysis is based on "seven pieces of company information" and publicly-available data. All results are mapped to the UN SDGs.
eFront ESG	An information collection portal that allows GPs and LPS to analyze portfolio ESG information and report such information to investors. LPs collect ESG policies and processes of GPs and their portfolios. GPs in turn collect ESG from their underlying assets.
iLEVEL	A portfolio monitoring and analytics solution offered by Ipreo that can be used to collect ESG data from portfolio companies and/or GPs and analyze materiality to enhance investment decisions.
Preqin Solutions	ESG & Impact module is a cloud solution for private capital firms to automate annual surveys, streamline KPI collection and aggregation, create custom action plans and centralize policies and due diligence documents.
Reporting 21	A portfolio monitoring product designed for ESG data to facilitate collection, analysis, comparison, consolidation and reporting of extra financial data: qualitative, quantitative and attachments. It can be used by GPs and LPs and portfolio companies for their own ESG monitoring and auditing.
RepRisk	RepRisk is a widely recognized source of ESG information on mainly private companies, providing ratings for each. *Our separate memorandum on RepRisk and other ESG Third Party Raters is available* ***here***.
Turnkey Group	An ESG platform and analytics tools that allows investors to measure and report the sustainability KPIs of their portfolio companies consistently and transparently. The platform is designed to allow comparison of ESG performance across portfolios and can be used to identify opportunities for internal cost-saving and strategic optimization.

If you have any questions regarding the matters covered in this publication, please contact any of the lawyers listed below or your regular Davis Polk contact.[8]

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[8] The authors gratefully acknowledge the assistance of law clerks and summer associates, Aru Gonzalez, Merisa Lyn Plavin, Hilary Smith and Michael Stenbring, and former associate, Yuko Masunaga, in preparing this memorandum.

Appendix A

PRI 2015 LP Responsible Investment DDQ

What are your ESG-related policies and how do ESG factors influence your investment beliefs?

- Do you have a policy that describes your approach to identifying and managing ESG factors within the investment and portfolio management processes? If so, please provide a copy. If not, please indicate whether you would consider adopting a responsible investment policy.
- What is the current implementation status of your responsible investment policy? Do you have any firm plans to develop your approach towards the management of ESG factors?
- Do you commit to any international standards, industry (association) guidelines, reporting frameworks, or initiatives that promote responsible investment practices?
- Do you make formal commitments relating to ESG integration in fund formation contracts, Limited Partnership Agreements or in side letters when requested by investors?

How do you identify and manage material ESG-related risks and use ESG factors to create value?

- How do you define the materiality of ESG factors? Please give 2-3 examples of ESG factors that you have identified as material to portfolio companies in your most recent fund.
- Describe your process for identifying and understanding (i) potentially material ESG risks, and (ii) ESG-related opportunities during due diligence.
- Once identified, how might the identification of (i) potentially material ESG risks, and (ii) ESG-related opportunities impact the investment decision?
- How are ESG risks and/or ESG-related opportunities reported to, considered and documented by the ultimate decision making body, such as the Investment Committee?
- During deal structuring, what is the process for integrating ESG-related considerations into the deal documentation and/or the post-investment action plan?
- Please describe how (i) oversight responsibilities, and (ii) implementation responsibilities for ESG integration are structured within your organisation. Please list the persons involved and describe their role, position within the organisation and how they are qualified for this role. Please also describe any external resources you may use.
- Do you provide training, assistance and/or external resources to your staff to help them understand and identify the relevance and importance of ESG factors in investment activities? If so, please describe what level of training is provided.

How do you contribute to portfolio companies' management of ESG-related risks and opportunities?

- Upon investing in a company, would you review existing compliance, sustainability or ethical business guidelines, or introduce new guidelines if necessary?
- What monitoring processes would you have in place to assess portfolio companies' management of ESG factors?

- Give 2-3 examples of how you have contributed to portfolio companies' management of ESG factors. Specify which initiative(s) you worked with management to identify and instigate, which you supported your portfolio company to achieve (and how) and/or what the portfolio company was already doing that you identified as existing good practice.
- How do you assess that adequate ESG-related competence exists at the portfolio company level? How do you ensure that portfolio company management devotes sufficient resources to manage ESG factors that have been identified?
- How do you use your interaction with the board to influence the portfolio company's management of ESG factors?
- Do you systematically incorporate ESG considerations into preparations for exit? If yes, please describe your approach. If not, please explain why.
- Do you measure whether your approach to ESG factors has affected the financial and/or ESG performance of your investments? If yes, please describe how you are able to determine these outcomes.

How can LPs monitor and, where necessary, ensure that the fund is operating consistently with agreed-upon ESG-related policies and practices, including disclosure of ESG-related incidents?

- Which channels do you use to communicate ESG-related information to LPs? Can you provide samples of ESG-related disclosures from an earlier fund? If not, please indicate whether you would consider introducing ESG-related disclosures.
- Is the management of ESG factors included on the agenda of the Limited Partners Advisory Committee and/or Annual General Meeting?
- Describe your approach to disclosing and following up on material ESG incidents to your LPs.