

Environmental, Social, and Corporate Governance (ESG) Disclosure Framework for Private Equity

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Introduction

A growing number of general partners (GPs) and their limited partner investors (LPs) are adopting a more structured approach to managing environmental, social, and corporate governance (ESG) risks and opportunities. One reason for this is a conviction that companies that address ESG issues can achieve better growth, cost savings, and profitability, while strengthening stakeholder relations and improving their brand and reputation. GPs, LPs, associations, and the private equity industry at large have an aligned interest in communicating how the management of ESG factors contributes positively to risk-adjusted returns.

This ESG Disclosure Framework (“the Framework”) is a response to changing and diverse expectations for the disclosure of ESG information. It sets forth due diligence questions (which may be effective for many LPs when considering whether or not to invest in a fund), and disclosure questions (which may be applicable during the life of a fund). The development of the Framework had the support of more than 40 LPs, more than 20 private equity associations, and a number of GPs from all over the world.

The Framework aims to:

- i. provide guidance on the rationale behind ESG-related questions
- ii. facilitate an informed discussion between GPs and their LPs, and
- iii. be used as a practical tool and not as a prescriptive rule.

Due to both the diverse nature of the private equity asset class and differing LP and GP approaches to ESG management and disclosure, what constitutes effective and relevant ESG disclosure can be defined only through discussions between a GP and its LPs in the context of the characteristics of a specific fund and with due regard to commercial confidentiality, legal privilege, liability, and resource constraints. “Disclosure” is used throughout this document to refer both to formal written reporting and to informal verbal communications, which may be regular and/or ad hoc in frequency.

As a starting point, the GP and relevant LPs should share their ESG strategy, policy, and practices with each other when forming and participating in a fund. They also should seek to ensure that the practice of ESG disclosure can be pragmatic, consistent, and cost-effective. LPs should welcome the GP’s current approach as a starting point for discussion. They can also consider working with the GP and other relevant LPs, if appropriate, to develop a consistent approach to ESG disclosure, including by using the Framework. LPs should only ask for information that they intend to use to meet their ESG objectives.

¹ Additional information on ESG can be found in the following:

1. IFC Sustainability Framework, available at:

http://www1.ifc.org/wps/wcm/connect/Topics_Ext_Content/IFC_External_Corporate_Site/IFC+Sustainability/Sustainability+Framework/

2. IFC Environmental and Social (ES) Toolkit, available at: <https://www.estoolkit.com/>

3. World Economic Forum Report: “Accelerating the Transition towards Sustainable Investing, available at:

http://www3.weforum.org/docs/WEF_IV_AcceleratingSustainableInvesting_Report_2011.pdf

4. UN PRI Guide for Limited Partners (2011), available at: http://intranet.unpri.org/resources/files/lp_guide_2.pdf

ESG Disclosure Framework: Limited Partner Objectives

Below is a set of eight objectives common to many LPs interested in adopting a more structured approach to ESG disclosure in private equity. GPs should seek to disclose information sufficient to enable those LPs to meet these eight objectives.

The subsequent sections provide a set of relevant questions that may be helpful in guiding the dialogue between LPs and GPs on ESG disclosure. The questions address the eight objectives listed below and provide non-exhaustive guidance that is not intended to be taken as implying mandatory adoption. This is a guidance tool that can be adapted to different situations. It can be implemented progressively over time and in response to changing practices. As with any kind of disclosure, a variety of practical and legal considerations may restrict what can be disclosed on ESG-related practices and outcomes. Where this is the case, an LP may benefit from understanding the nature of the obstacles.

Section 1: Disclosures during fund-raising

During fund-raising, a GP should seek to disclose information sufficient to enable an LP that has expressed an interest in ESG management to:

1. Assess if the GP is aligned with the LP's ESG-related policy and investment beliefs.
2. Assess the GP's policies, processes, and systems for identifying ESG-related value drivers and managing material ESG-related risks; and to identify possible areas for future development.
3. Understand if and how the GP influences and supports its portfolio companies' management of ESG related risks and pursuit of ESG-related opportunities.
4. Assess how the GP will help the LP to monitor and, where necessary, ensure that the GP is acting consistent with the agreed-upon ESG-related policies and practices as set forth at fund formation.
5. Assess the GP's approach to managing and disclosing material incidents at the GP and portfolio companies.

Section 2: Disclosures during the life of a fund

During the life of a fund, a GP should seek to disclose information sufficient to enable an LP that has expressed an interest in ESG management to:

6. Establish if a GP is acting in a manner consistent with the GP's investment policies, processes, and agreed-upon fund terms regarding ESG management.
7. Understand positive and negative ESG-related developments that may impact portfolio companies in the fund.
8. Determine if responses to GP and portfolio company incidents and incident reporting are consistent with relevant investment terms, the fund's policies, and the LP-stated objectives regarding incident disclosure.

Section 1:

Disclosures during fund-raising

GPs and LPs devote significant attention and resources during the fund-raising due diligence process to ensure that their interests are aligned and that expectations of future reporting and behaviour are agreed upon. This is done because of the partnership nature of the GP-LP relationship; the long-term, illiquid, and closed-ended structure of private equity fund investments; and the often “blind pool” nature of fund investments.

Posing the questions below early in the due diligence process can be a good basis for an LP to gain an understanding of the GP’s approach to ESG integration and how it may change over the life of a fund. This information should be considered by the LP in the context of the fund’s specific investment strategy (e.g., target sectors, geographic focus, stage of investment). In most instances, disclosures can be usefully complemented by real-life examples.

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

Objective: The LP asks this question in order to assess if the GP is aligned with the LP’s ESG-related policy and investment beliefs.

An LP would normally expect to understand a GP’s approach to ESG management and review all relevant policies, processes and/or systems that guide a GP’s operations and investment decision-making process. A GP could provide examples of how ESG-related risks and opportunities could have materially impacted past or current portfolio companies. A GP could provide copies of any ESG-related conditions and terms previously agreed upon in current or earlier funds. LPs with exclusion policies would expect to discuss how a GP could accommodate them, including if the LP’s exclusion policy changes during the life of the fund.

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

Objective: The LP asks this question in order to assess how the GP implements relevant policies, processes, and/or systems for identifying ESG-related value-drivers and managing material ESG-related risks; and to identify possible areas for future development.

An LP would normally expect a GP to demonstrate how its processes will enable consistent integration of ESG factors into the due diligence process of portfolio companies, and during ownership. As an example, a GP may include ESG-specific information in an investment memo on a portfolio company, and could provide to an LP that section of the investment memo as practical evidence. A GP could also communicate who is responsible at the fund for the ESG performance of portfolio companies (e.g., a member of the GP’s investment committee). A GP could indicate its internal and external sources of expertise on ESG issues, and could provide access to relevant staff, including risk management and investment professionals.

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

Objective: The LP asks this question in order to understand if and how the GP influences and supports its portfolio companies’ management of ESG-related risks and pursuit of ESG-related opportunities.

An LP would normally expect to be informed of how a GP monitors and, where relevant, contributes to portfolio companies’ approaches to ESG at different stages of the investment process, including at exit. The GP could explain its expectations of portfolio company board composition, culture, and effectiveness, and whether its approach depends on factors such as majority or minority ownership. The GP could disclose how it expects ESG factors to be addressed by the portfolio company and expressed through company strategy, risk management, and reporting to the GP. The GP could also disclose who at the portfolio company is responsible for ESG performance, as well as the range of actions the GP may take in the event that the portfolio company management does not adequately address ESG factors. The GP could also explain its

expectations on portfolio company executive remuneration policy (including consideration of ESG factors where relevant). The GP could set forth expectations on how portfolio companies approach stakeholder engagement and ESG reporting.

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

Objective: The LP asks this question in order to assess how the GP will help the LP to monitor and, where necessary, ensure that the GP is in compliance with agreed-upon ESG-related policies and practices as set out at fund formation.

An LP would normally expect to know in advance the nature and frequency of ESG-related reporting and disclosures during the life of the fund. A GP could describe these disclosures and could provide the LP with samples of ESG-related disclosures from earlier funds. An LP may also want to understand the mechanisms through which it could raise potential concerns, and any relevant remedies. A GP could, for example, outline if ESG issues are included on the agenda of the Limited Partners Advisory Committee and/or Annual General Meeting. It could also state the circumstances under which an LP may discuss ESG issues with investment professionals, other members of the GP's team and, where applicable, portfolio company management.

5. What is your approach to managing and disclosing material ESG-related incidents at the GP and portfolio companies?

Objective: An ESG-related incident is a significant and unexpected event at a portfolio company or at a GP that may materially impact the reputation of the portfolio company, GP and/or LP. The LP asks this question both to inform the LP's own internal reputation risk management processes and to enable the LP to assess the emergency preparedness and response processes in operation within the fund.

An LP would normally expect to discuss with the GP the types of material ESG incidents for which the GP could provide disclosure, taking as a starting point the GP's views on the most appropriate types of disclosures. An LP would expect this discussion to address the appropriate timing of disclosure (e.g., immediately; as reasonably practical; etc.) and related confidentiality considerations. A GP could describe its approach to working with portfolio companies to manage incidents, including relevant policies and processes; these could differentiate between internal and external incidents or events. A GP could explain the types of disclosure an LP could expect to get at the time of an incident or event, during its management, and after it has been resolved. Redacted examples of previous incident disclosures could be provided for the LP to review.

Section 2: Disclosures during the life of a fund

Disclosures during the life of the fund are intended to enable an LP to:

- Verify that a Fund continues to be managed according to the ESG policies, practices and beliefs agreed and communicated at formation;
- Understand material changes of ESG risks and opportunities in the fund's portfolio; and
- Be informed about material ESG incidents.

Disclosures could therefore address the three basic questions below. Any material ESG-related information could be integrated along with other material information in regular, periodic disclosures. The GP could disclose other information that it believes is relevant for LPs to assess its ESG implementation and actions.

6. How are you implementing relevant investment policies, processes, and fund terms regarding ESG management?

Objective: The LP asks this question to establish if a GP is acting in a manner consistent with investment policies, processes, and fund terms regarding ESG management.

Throughout the life of a fund, an LP would normally expect to be informed of any changes to the GP's ESG-related policies and how these policies are being implemented. A GP could disclose actions it has taken to further develop its approach to managing ESG opportunities and risks in the fund. This could include additions or revisions to existing policies, strategies, or management systems, including ESG disclosures. A GP could disclose how the integration of ESG factors has materially impacted investment decisions and/or ownership activities in the relevant period, including any investments declined or proactively structured due to ESG issues. A GP could also disclose how its systems and controls assess the degree to which portfolio companies operate consistently with the agreed-upon ESG policy. The disclosure could also outline the GP's role and actions in identifying or managing ESG opportunities and

risks in portfolio companies (e.g., helping to share best practices within its portfolio of companies).

7. Have there been any material changes to ESG risks and/or opportunities in the underlying portfolio?

Objective: The LP asks this question to understand positive or negative ESG developments that may impact portfolio companies in the fund.

An LP would normally expect to be informed within regular, periodic disclosures of any material changes to the ESG performance and/or profile of all companies within a fund in which the LP is invested. A GP could outline any material developments that have occurred at individual portfolio companies, which could be summarised at the portfolio company or fund level. This could include developments in how material ESG issues are managed by portfolio companies as well as any material changes in ESG opportunities and/or risks, including any regulatory changes. LPs may find this information more useful if it includes performance measurements and is presented in a manner that enables comparison over the life of the fund.

8. Are there any material ESG-related incidents at the GP or portfolio companies that should be disclosed to relevant LPs outside of regular, periodic disclosures?

Objective: The LP asks this question to determine if responses to portfolio-level incidents and incident reporting are consistent with relevant investment terms, the fund's policies, and LP-stated objectives regarding incident disclosure.

LPs that have indicated to a GP their interest in ESG-related incidents would like to ensure that they are disclosed in a timely manner (within the boundaries of their legal agreements with other parties and regulatory or legislative restrictions). These LPs would normally expect the GP to be able to demonstrate that they are reacting in a way consistent with the fund's investment terms and policies regarding incident disclosure. A GP could provide information on ESG-related incidents in portfolio companies and at the GP, including actions taken in response to incidents. Even though the ultimate disclosure may be formal, it may be appropriate for initial disclosures on ESG-related incidents to be verbal or informal.