PRI
Principles for Responsible Investment

An investor initiative in partnership with UNEP FI and the UN Global Compact

Responsible Investment in Private Equity

A Guide for Limited Partners

THE GLOBAL COMPACT

UNEP Finance Initiative
Innovative financing for sustainability

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About The PRI

The Principles for Responsible Investment (PRI) provide a framework for helping investors build environmental, social and governance considerations into the investment process, thereby achieving better long-term returns and more sustainable markets. The six Principles of the PRI Initiative were developed by, and for, institutional asset owners such as large pension funds and fund managers.

The Initiative now has over 500 signatories made up of financial institutions from 32 countries with roughly US$18 trillion of assets under management. The Principles themselves, a full list of signatories and more information can be found at www.unpri.org.

PRI signatories make a commitment to apply the Principles across all asset classes.
It is up to each signatory to decide how best to apply the Principles to their investment activity.
Roughly 75% of PRI signatories have developed their own tailored Responsible Investment policy.
Where necessary, and at the request of the Board, the PRI Secretariat convenes groups of experts to consider how to support signatories' continuous improvement in implementing the Principles.
The Board requested the PRI Secretariat to initiate work on Private Equity in November 2007.
Information on the PRI's work in other asset classes is available at www.unpri.org

About This Guide

This guide describes some of the unique characteristics of private equity investments and provides suggestions on how the PRI Principles could be applied to the asset class. It aims to help LPs assess the extent to which a GP's investment and ownership processes are consistent with the LP's own commitments as a PRI signatory. Its scope addresses engagement and information that an LP can consider both before investing in a fund and during the life of that fund. The guide can be applied to any type of PE investment including: Venture Capital; Mid-Market; Large Buy-Out; Mezzanine; Secondary investments; Distressed and Special Situations; and Funds of Funds.

This guide should not be used as a checklist: it is a starting point from which PRI signatories can develop their own approach to Responsible Investment in the private equity asset class. There is presently not enough widespread experience with the application of the PRI Principles in private equity investments to define "best practice". This guide is targeted at investors (Limited Partners), but may also be of use to private equity firms (General Partners).

Nothing in this guide intends to imply that PRI signatories should dissuade a private equity fund from investing in portfolio companies based on their location, sector or the nature of their ESG impacts. To the contrary, significant value may be derived from investing in and improving companies with significant but poorly managed ESG-related risks or opportunities. While the application of this guide intends to ensure that the scope of information on which investment and ownership decisions are made on behalf of a fund includes ESG issues, it does not intend to alter the GP's role as decision-maker. This guide also does not imply that new channels are necessarily required for the communication of ESG-related information.

The PRI Board encourages all PRI signatories to use this guide as a basis for developing their own approaches to Responsible Investment in Private Equity. We intend to include a question in the 2010 reporting and assessment tool process on the degree to which this Guide has been helpful. We also intend to undertake an extended period of engagement on the Guide during 2009-2010. Based on this and other information, the PRI Secretariat will review and, where necessary, revise this guide in 2010.

This guide was developed by the PRI's Steering Committee on Private Equity. The Steering Committee was established in September 2008 with representatives from asset owners, asset managers, private equity houses and industry associations. The Steering Committee included PRI signatories and non-signatories, and reported to the PRI Board.

The Steering Committee was managed by Tom Rotherham, Kan Xi and Jerome Tagger, and its members were:

Actis (Ritu Kumar), AlpInvest (Wim Borgdorff, Maaike van der Schoot), AP2 (Carl Rosen), APG (Rob Lake), Blue Wolf Capital Management (Mike Musuraca), CalPERS (Jesus Arguelles), CalSTRS (Margot Wirth), Doughty Hanson (Guy Paisner), EVCA (Javier Echarri, Serge Raicher, Vincent Neate), La Caisse de dépôt et placement du Québec (Pierre Piche, Michel Lefebvre), La Caisse des Dépôts et Consignations (Patricia Jeanjean), New Zealand Superannuation Fund (Anne-Maree O'Connor), Pantheon (Carol Kennedy, Helen Steers), PCG Asset Management (Michelle Davidson), PGGM (Leo Lueb), Robeco (Stefan den Doelder), UN Global Compact (Gavin Power). USS (David Russell), Washington State Investment Board (Liz Mendizabal). Apax Partners, The Blackstone Group, The Carlyle Group, Kohlberg, Kravis Roberts & Co, Silver Lake, TPG, Permira and PEC President Doug Lowenstein also participated, representing the Private Equity Council (whose other members are Apollo Global Management, Bain Capital Partners, Hellman & Friedman, Madison Dearborn Partners, Providence Equity Partners and TPG).

Introduction

Responsible investment and private equity

Both public and private equity investors ultimately invest in the same underlying asset: companies. As a result, much of the ESG-related research, analysis and services used by public equity investors may also be of use to private equity investors. Despite the similarity in the underlying asset, private equity (PE) has a number of unique characteristics that should be considered when an investor is developing an approach to Responsible Investment.

PE funds are generally structured as Limited Partnerships, which are managed by a General Partner (GP). Investors, known as Limited Partners (LP), subscribe for limited partnership interests by investing in a fund. As managers of the fund, GPs are responsible for sourcing and analyzing investments, executing on investment decisions, monitoring and advising the fund's investments, and eventually selling the portfolio companies.

Some of the key characteristics of PE include:

- An investment in PE is a long-term investment: LPs generally commit capital to a fund for a period in excess of 7 years. The fund itself is a blind pool: the underlying assets (portfolio companies) are not known until fund is operational. The LP's investment decision is therefore based significantly on the nature of the fund's mandate and the quality and history of the GP.
- An investment in a PE fund is relatively illiquid. The LP cannot easily sell partnership interests (a decision which often requires permission from the GP), and changes to the investment mandate may require negotiation with all other LPs.
- Other than the initial decision to subscribe to a fund managed by a particular GP, almost all of the discretion over investment decision-making and ownership activities lies with the GP.
- A GP's request for capital from the LPs to make an investment can be a relatively quick process, not giving LPs much time for consideration or review of the investment proposition.
- Although the ownership period of portfolio companies is often as long as 5 years, PE is a buy-to-sell model, not buy-to-own. All investments must be sold within the life of the fund.
- GPs seek significant influence or control over their investments, and frequently purchase a full or majority stake in the portfolio company and nominate a Board member / members.
- Thus, in many instances, the GP acts as both an asset manager and as a company Director (i.e. with influence over corporate strategy, a governance role, and potentially direct corporate management).
- The ownership and governance model allows for a much closer alignment of interests between asset owners, the investment manager and corporate management, and therefore there is a potentially higher likelihood that owners can influence how managers address ESG issues within the underlying portfolio companies.
- There is frequently a significant level of disclosure to LPs, even if public disclosure is often limited.
- Because the relationship between LPs and GPs is structured as a legal partnership, GPs are frequently receptive to ongoing engagement and regular dialogue with their LPs.

Guidance for Limited Partners

General

A broad range of actors may contribute to and influence an LP's investment decision-making and ownership process. The more of these actors that are aware of, and capable to act upon, an LP's commitment to integrate environmental, social and governance (ESG) issues into their private equity investments, the more successful the approach will be.

1. LPs should develop, and communicate to relevant parties, a policy statement outlining their approach to Responsible Investment in Private Equity.
2. LPs should ensure that their staff, consultants, service providers, intermediaries and GPs are aware of their approach to Responsible Investment, and that staff dealing directly with ESG issues have access to relevant training and/or sources of specialist expertise.
3. LPs should seek to ensure that their internal due diligence and fund selection processes give due regard to ESG criteria, for instance by developing investment analysis criteria, due diligence tools or including a section in the investment recommendation report assessing the GP's approach to ESG.
4. LPs should include ESG criteria in the mandates that they give intermediaries (e.g. investment consultants) or service providers acting on their behalf in the fund selection or due diligence process.
5. LPs should validate their assessment of whether GPs, intermediaries and service providers meet relevant ESG criteria. This could be done by assessing their policies, systems and/or access to expertise, and/or by reviewing past examples of ESG integration.

Pre-investment stage

An LP is a passive partner in the management of a fund: other than the initial decision to subscribe to a fund, investment and risk management discretion is generally delegated to the GP. As a result, If ESG issues are not formally addressed prior to signing an investment agreement it may be more difficult to do so afterwards.

Prior to investing in a fund, an LP should actively ensure that the GP has the policies, systems and expertise needed to integrate ESG considerations into their investment decisions and ownership activities. Prior to investing, the LP should also discuss the ESG-related disclosures that the GP can provide during the life of the fund.

Due Diligence

6. LPs could provide GPs with a statement explaining the LP's commitments under the Principles for Responsible Investment, including where relevant a copy of the LP's Responsible Investment policy, and request information on how the GP could help ensure that these commitments and/or policy are applied within the fund.

7. LPs could ask GPs whether they have an ESG policy, what this entails and what the status of implementation is.

8. LPs could ask for examples of how GPs have in the past identified and addressed ESG-related risks and opportunities in their portfolio.

9. LPs could, through informal discussions, assess the degree to which the GP understands the potential financial implications of, and is committed to improving their management of, ESG issues.

10. LPs could include ESG-specific questions in due diligence questionnaires (see Annex 1).

11. Given the duration of the investment period, and the likelihood that GPs can further develop their approach to ESG over the life of a fund, LPs should consider whether failure of GPs to provide adequate responses during the due diligence process should necessarily result in a decision not to invest. An LP could instead decide to invest but then to engage with the GP in order to encourage and support improved integration of ESG issues in the management of the fund. In such cases, recognition by the GP of the importance of ESG issues and/or a formal commitment to address them may be sufficient if the LP follows up with active engagement.

12. Noting that they may not have the resources to actively engage with all of the GPs in whose funds they have invested, LPs could use the information obtained during the due diligence process to prioritise which GPs warrant engagement on what issues.

Documentation

13. Commitments related to ESG and Responsible Investment should be included in documentation provided by the GP to the LP prior to investing in a fund. This documentation could include:

- The GP's Responsible Investment policy, or other information on how ESG issues are addressed during the investment and ownership processes

- Recognition of the LP's commitment to the PRI Principles, or of the LP's Responsible Investment policy

- A description of the ESG-related information that an LP can expect to receive during the life of a fund, for instance in existing:
  — Annual reports on the fund and/or portfolio companies
  — Capital calls
  — Investment memos

- A statement on whether, and if so how, the GP would provide updates if the GP deems a significant or material ESG issue to have arisen in a portfolio company

Post-investment stage

Once invested in a fund, an LP generally has only a passive role in the ownership activities. While many funds establish an Advisory Committee to enable the GP to engage with LPs, responsibility for decision-making lies with the GP. As a result, LPs should focus on monitoring how the GP is integrating ESG issues into their investment decisions and ownership activities, and engaging with the GP on specific ESG issues. While the GP may be able to provide a broad range of detailed ESG-related information, including at both fund and portfolio company-level, LPs should ask only for information that they intend to analyse and use, and should recognise that commercially sensitive information may in some instances have to remain confidential.

Monitoring

14. LPs could request information from the GP either formally (e.g. email, minuted meetings, annual report, fund reports, portfolio company reports) or informally (e.g. telephone calls, un-minuted meetings).

15. Where a commitment relating to ESG issues has been communicated by the GP (e.g. in a Responsible Investment policy), LPs could request formal updates, for example in annual reports or other existing channels.

16. LPs could request that their GPs develop criteria and procedures for notifying the LP should the GP deem that significant or material ESG-related risks have arisen during ownership.

17. LPs could encourage their GPs to report on the application of their own ESG policies and procedures at their Annual meetings or at meetings of their Fund Advisory Committees.

18. In accordance with Principles 3 and 6 of the PRI, LPs should encourage broader disclosure by GPs of non-confidential information on ESG-related issues to other stakeholders.

Engagement

19. LPs could attempt to use both formal and informal engagement with the GP to foster dialogue, as appropriate, with respect to the importance of and approaches to Responsible Investment and ESG issues.

20. LPs could encourage the GP to develop its own RI policy, which should inform the GP's engagement with its portfolio companies, building for instance on the PRI, the UN Global Compact and the US Private Equity Council's (PEC) Guidelines.

21. Internally, LPs could share ESG-related research, analyst notes and other information between their public and private equity teams. This could include sector- and issue-based analysis.

22. Where LPs believe they have identified a material ESG risk or opportunity, they could request the GP to engage with relevant portfolio companies and to report back to the LPs.

23. LPs could work with peers and GPs to further develop and improve ESG standards and promote sustainability within the PE sector.

24. LPs could encourage their GPs to become a PRI signatory, and to participate in the PRI Private Equity Workstream.

Annex 1

Topics for LPs' questionnaires and engagement

The following list provides an overview of the kinds of questions that could help LPs integrate ESG issues into their due diligence processes and in their ongoing engagement with GPs. This is not intended as a checklist. Each LP should develop an approach suited to their investment style and commercial interests. LPs should also be careful not to ask for a volume or detail of information that will not be used. However, consideration should be given to including elements of each of the six headings below. When developing an approach, LPs could draw on their experience of ESG in public equities.

Because different funds may have different exposure to ESG-related risks and opportunities, and because different GPs may have different capacity to address ESG issues, LPs may choose to apply different questions to different GPs.

Fund mandate

LPs should inquire into the nature of the fund mandate in order to determine whether the fund, for example:

- **i.** has a focus on sustainability-related themes (e.g. clean technology, education, health)
- **ii.** focuses on industrial sectors and/or countries that the LP considers to have high ESG-related risk/opportunity profiles
- **iii.** has an investment policy consistent with the LP's own ESG-related exclusions policy (e.g. investments will not be made in specific sectors or countries)

Policies and processes

LPs should inquire into whether the GP has a Responsible Investment policy, or another formalised and consistent approach for integrating ESG factors into investment decision-making and ownership activities. This could include whether the GP, for example:

- **i.** is a signatory to the PRI, or has adopted any other ESG-related standards or codes
- **ii.** has included ESG-related terms in previous Limited Partner Agreements (LPA) or side letters
- **iii.** considers ESG issues in the due diligence process for every potential portfolio company
- **iv.** includes ESG factors in internal audits at the fund and portfolio company level
- **v.** has processes in place to ensure that ESG issues are managed at the portfolio company level
- **vi.** has a policy on conflicts of interest

ESG expertise

LPs should inquire into whether the GP has access to particularly important types of ESG-related expertise, and whether the expertise is internal; on fund advisory committees; from external consultants and/or within portfolio companies.

Disclosure and Engagement

LPs should inquire into the nature and frequency of information that the GP will provide during the life of the fund, which would enable the LP to ensure that the fund is being operated in a manner consistent with the LP's Responsible Investment policy and/or commitments as a signatory to the PRI. This could include formal and informal communication through a number of channels, for example:

- **i.** Capital calls
- **ii.** Investment memos
- **iii.** reporting at the fund level
- **iv.** reporting at the portfolio company level
- **v.** communication with, and discussion within, the advisory committee
- **vi.** annual general meetings
- **vii.** the GP's approach to ongoing engagement with LPs
- **viii.** the GP's approach to public disclosure

Portfolio companies

LPs should inquire into the how the GP engages with its portfolio companies on ESG factors. This could include, for example:

- **i.** whether ESG factors are within the scope of responsibilities of GP-appointed Directors
- **ii.** the type and frequency of ESG information reported by the portfolio company to the GP, and whether this includes the company's supply-chain
- **iii.** how GPs assess portfolio companies' compliance with ESG-related laws and regulations
- **iv.** the use of independent experts or third party audits
- **v.** policies to encourage portfolio companies to adopt external standards or codes, including for example the UN Global Compact
- **vi.** examples of previous involvement in ESG decision-making within a portfolio company

Specific ESG issues

LPs should also inquire into a GP's policies on, and the performance of portfolio companies against, ESG factors that the LP has prioritised, for example climate change, bribery and corruption, health & safety or human rights. When considering which ESG factors to prioritise, LPs may find it useful to build on sector- or issue-based analysis undertaken by public equities analysts or investors.

Annex 2

The Principles for Responsible Investment and this guide

This Guide outlines possible actions that can help LPs apply the PRI Principles to their private equity investments. The index below indicates where guidance applicable to specific PRI Principles can be found. However, the effectiveness of some of the actions suggested in this Guide may be contingent on the application of other elements, and so caution should be given when applying only parts of the Guide.

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

Possible actions are contained in:
Guidance: General
Guidance: Pre-Investment Stage

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

Possible actions are contained in:
Guidance: General
Guidance: Pre-Investment Stage
Guidance: Post-Investment Stage
Annex 1: Suggested questions on Disclosure and Engagement; Portfolio Companies

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

Possible actions are contained in:
Guidance: General
Guidance: Pre-Investment Stage
Guidance: Post-Investment Stage
Annex 1: Suggested questions on Fund mandate; Policies and Processes; ESG Expertise; Disclosure and Engagement; Portfolio Companies; and Specific ESG Issues

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

Possible actions are contained in:
Guidance: General
Guidance: Pre-Investment Stage
Guidance: Post-Investment Stage

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

Possible actions are contained in:
Guidance: General
Guidance: Post-Investment Stage

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

Possible actions are contained in:
Guidance: General

Annex 3

Indicative survey of LP expectations on ESG issues

The scope of this toolkit was informed by a survey of 15 global LPs who are participating in the PRI PE Steering Committee. While not representative of all PRI signatories, these LPs represent over $USD100 Billion in assets allocated to private equity investments, and include some of the world's biggest institutional investors.

The survey was completed in January 2009 and sought to identify what kind of ESG-related information some leading LPs' expect from their GPs. The questions were grouped into three categories:

— General
— Pre-Investment (due diligence)
— Post-Investment (ownership)

Results of the survey

*N.B. Figures indicate percentage of respondents answering "yes".

General

Would you expect all your potential and future GPs to respond to a minimum set of ESG-related questions as defined by your organization?	**93.3%**
If yes, would you expect all PRI signatories to include some of the same basic ESG-related questions in their own relationships with their GPs?	**66.7%**

Pre-investment Stage

Would you expect a GP to provide you with a copy of a Responsible Investment policy or mission statement?	**80.0%**
Would you expect a GP to provide evidence of how their Responsible Investment policy is implemented?	**93.3%**
Would you expect a GP to provide examples of how their Responsible Investment policy has influenced decision-making?	**93.3%**
Would you expect a GP to make either all or part of their Responsible Investment policy publicly available?	**73.3%**
Would you expect a GP to sign a side letter that acknowledges your Responsible Investment policy or otherwise addresses ESG issues?	**73.3%**
Would you expect to be informed of whether a GP has staff dedicated to RI?	**100.0%**
Would you expect a GP to inform you of whether they are a member of the PRI or other similar organizations?	**100.0%**

Post-investment Stage

Would you expect a GP to provide ESG-related information in annual reports at the fund level?	**93.3%**
Would you expect a GP to provide you with an annual report at the GP level?	**93.3%**
If you would expect a GP to provide an annual report, would you also expect this to include information on Responsible Investment?	**93.3%**
If you would expect a GP to provide an annual report, would you also expect this to be made publicly available?	**7.1%**
Would you expect a GP to include relevant ESG-related information in annual reporting to you on Portfolio Companies?	**85.7%**
Would you expect a GP to include relevant ESG-related information in quarterly reporting to you on Portfolio Companies?	**46.7%**
Would you expect an annual statement from the GPs confirming that their Responsible Investment policy, or specific ESG terms included in a side letter, was complied with?	**64.3%**
Would you expect relevant ESG issues to be integrated into capital calls or investment memos?	**85.7%**
Would you expect to have an annual opportunity to discuss ESG issues with a GP?	**100.0%**
If so, would you expect this opportunity to discuss ESG issues with a GP to be open to all interested LPs in the fund?	**66.7%**

Annex 4

Additional sources of guidance

When developing their own approach to Responsible Investment in private equity, Limited Partners can draw on a broad range of other sources of guidance, including:

UN Conventions and Initiatives

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

Other Intergovernmental Organisations

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

International Financial Institutions

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

Private Equity Associations:

- US PEC Guidelines for Responsible Investment (http://www.privateequitycouncil.org/)
- BVCA Walker Guidelines (http://www.walker-gmg.co.uk/)
- EVCA Corporate Governance Guidelines (http://www.evca.eu/toolbox/default.aspx?id=504)

A comprehensive list of public and private codes, standards and initiatives that may be applicable to portfolio companies is available in the draft ISO 26000 Guidance on Social Responsibility.

Share your experience with Responsible Investment in Private Equity

The PRI will undertake an extended period of engagement on the Guide during 2009-2010. Based on this and other information, the PRI Secretariat will review and, where necessary, revise this guide in 2010. If you would like to provide input to this review process, please contact info@unpri.org.

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