WHITE PAPER

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ESG in Private Equity: How to Write a Responsible Investment Policy

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Introduction: The Mainstreaming of Responsible Investing

Over the past 10 years, the private equity sector has seen responsible investment approaches move from exception to expectation. Formalized integration of environmental, social, and governance (ESG) considerations is becoming the norm.

A diverse group of stakeholders—from investors to portfolio companies to employees—increasingly expect that General Partners (GPs) demonstrate that they invest responsibly and incorporate ESG factors into their investment decisions.[1] Furthermore, as ESG factors increasingly affect the business value of portfolio companies, GPs are recognizing the benefits of taking a more structured approach to ESG integration.

As a result, GPs that do not yet have formalized approaches to responsible investment are moving quickly to develop the policies, management systems, reporting tools, and follow-up initiatives to meet evolving stakeholder expectations. GPs already pursuing formalized approaches ought to update their efforts on an ongoing basis to match evolving practices. For all firms[2], a meaningful policy is fundamental to responsible investment and ESG integration.

The challenge is that—while there is important and useful research available on ESG management in private equity—there is limited current guidance about what should go into a responsible investment policy. Many firms end up using generic language, leading to policies that are not well-tailored to the individual firm's investment profile, that inadequately address stakeholder interests, and that establish commitments the firm may not be prepared to uphold. Such generic policies create a disconnect between the firm's investment strategy and ultimate ESG objectives, leading to less effective and efficient approaches.

This paper will outline a straightforward approach, principles, and tips to use in developing a responsible investment policy. We aim to provide firms with general guidance to facilitate the development of strong policies that address common policy considerations while at the same time tailoring the language to suit its unique

[1] 2015 CFA Institute Survey of institutional investors—including many public pension funds—found that 73% of respondents incorporate ESG factors into their investment decisions.

[2] We use the terms GPs and firms interchangeably in this paper.

circumstances and material ESG considerations. In doing so, we hope that we will enable the adoption of more effective responsible investment approaches and ESG management practices at firms and their portfolio companies, and to encourage capital deployment towards a more sustainable future.

What Is a Responsible Investment Policy?

> DEFINITION OF RESPONSIBLE INVESTMENT POLICY
>
> The Principles for Responsible Investment (PRI) defines an investment policy as an overall statement that actualizes the approach on how your organization will achieve its identified mission and will build on your investment strategy, outline your investment objectives, and give guidance to investment processes as well as your standards for measuring success/performance.

A responsible investment policy is a firm's commitment to incorporate ESG factors into investment decisions to better manage risk and generate sustainable, long-term returns. At minimum, the policy lays out the firm's overall objectives, approach, governance, strategy, and scope in identifying and managing ESG factors across the investment lifecycle. Firms refer to their policies in varying ways, such as Responsible Investment Policy, ESG Policy, or Sustainability Policy.

It is considered best practice to make the policy available on the firm's website, to Limited Partners (LPs), and incorporated into Fund Placement Documents and/or Limited Partnership Agreements.

A responsible investment policy ought to be principles-based and written in simple, clear, and non-legalistic language. This framing makes it more practical for users within an organization; the goal of a policy is to encourage investment professionals to think about impacts and the value implications of investments within a prescribed framework and to seek additional advice when unsure. In contrast, a policy focused on rules, prescriptive instructions, legalistic strictures, or explicit exclusions may not provide meaningful direction when uncertainties arise. It also risks making the responsible investment program compliance-based and non-strategic.[3]

Why Develop a Responsible Investment Policy?

A responsible investment policy explains how responsible investment relates to the GP's investment strategy and its approach to ESG integration. It also serves as the cornerstone of a firm's responsible investment efforts in the following ways:

» **Establishes a "North Star":** The principles outlined in a policy provide direction to employees, LPs, and other external stakeholders in understanding the firm's core beliefs and resolving uncertainty around challenging situations.

» **Communicates commitments to LPs:** A policy document ought to present a clear, consolidated, effective statement of policy to LPs and provide detail to respond to their increasingly sophisticated requests, thereby saving time and promoting consistency.

[3] Nevertheless, policies do provide clarity about a firm's investment exclusions and prohibited activities.

- **Aligns expectations and builds trust with broader stakeholders:** By articulating ambitions and commitments, a policy builds trust among relevant stakeholders including investors, investment professionals, regulators, portfolio company employees, and local communities where companies operate.

- **Establishes the framework for a consistent approach to implementation:** Provides guidance on how to implement a firm's commitment to integrate ESG considerations by clearly describing the scope, governance structure, actions, and reporting to support the integration. A GP may also develop additional guidance, tools, or templates to support this process.

Who Is Responsible for Developing the Policy?

A combination of senior oversight and cross-functional integration is critical to developing a responsible investment policy. The policy also describes who is responsible for approving the policy and who is accountable for its success.

SENIOR MANAGEMENT LEADS POLICY CREATION

Typically, an executive or member of senior management will lead the process of drafting the policy, securing buy-in, and assigning resources needed for its implementation. Such senior oversight is critical for the success of the policy development and implementation. The lead person may get support from a team member in managing the day-to-day activities of stakeholder engagement, content development, drafting, and sign-off.
The responsibilities of the individual leading policy development include:

- Defining the ambition and business case for policy implementation

- Drafting the policy language

- Engaging key internal stakeholders, such as those on a cross-functional committee (see description below) to seek input and establish buy-in throughout the organization

- Identifying and securing assistance from external stakeholders or partners, as useful

- Leading the sign-off process at various levels and divisions such as Risk Management, Legal and Compliance, Investor Relations, Public Affairs, etc.

- Developing an implementation roadmap that covers investment team trainings, procedures, and controls that operationalize the policy commitments.

Once the policy is adopted, it is crucial for a senior person to have ultimate ownership for endorsing, implementing, and promoting adherence to the policy.

A COMMITTEE TO ALIGN INTERNAL STAKEHOLDERS

It is common and best practice to establish a cross-functional working group or committee to help steer the policy through the different steps of policy development. Policies have the most success when key individuals at the firm provide feedback early in the process. In many cases, the working group or committee will retain the responsibility to make revisions and support implementation of the policy over the medium- to long-term. It is also essential for investment and portfolio teams to play a role in policy development and sign-off in order to develop a policy that can be successfully operationalized.

The cross-functional committee's responsibilities include:

» Providing input, signing-off, and promoting implementation in different parts of the organization

» Socializing the policy and engaging across different functions such as Investor Relations, Client Relations, Legal, Public Affairs, regional teams, etc.

» Enhancing general awareness of responsible investing and the new policy, serving as internal champions for the effort

» Supporting internal training for investment professionals on effective implementation of the policy.

What Are the Key Components of a Policy?

There is no one-size-fits-all approach to responsible investment: The investment strategy of the fund will be key to determine the responsible investment approach, and the responsible investment policy ought to be tailored to the investment profile and beliefs of the fund. At the same time, several foundational elements are considered best practice to include and should be addressed in the policy.

BSR recommends that the policy statement indicate that the firm will focus on "material" ESG issues. That is, the firm's responsible investment commitments chiefly apply to situations in which a particular ESG issue is deemed material, and the policy should define what that means. Such a strategic approach can allay front office concerns that a responsible investment policy means spending resources on extraneous or superfluous considerations. Firms that have particular focus areas (e.g. by sector, geography, business model, or asset class) should also consider describing the material issues they will commonly focus on.

Table 1: **Common definitions of materiality**

Source	Definition
Global Reporting Initiative (GRI) Standards Definition[4]	The materiality principle identifies material topics based on the following two dimensions: » The significance of the organization's economic, environmental, and social impacts » Their substantive influence on the assessments and decisions of stakeholders
Sustainability Accounting Standards Board (SASB)[5]	"[Material issues are matters that] either individually or in the aggregate, are important to the fair representation of an entity's financial condition and operational performance … [information that is] necessary for a reasonable investor to make informed investment decisions. "Presenting a substantial likelihood that the disclosure of the omitted fact would have been viewed by a reasonable investor as having substantially altered the total mix of information made available."
The Limited Partners' Responsible Investment Due Diligence Questionnaire[6]	"Materiality encompasses quantifiable impacts on financial performance and investment returns, reputational risks, and broader potential consequences on business (such as license to operate). The GP's determination of materiality should be based on both their own assessment of materiality and an assessment of their LPs' views."

[4] "Questions About Materiality and Topic Boundary," GRI Standards, accessed on March 1, 2019, https://www.globalreporting.org/standards/questions- and-feedback/materiality-and-topic-boundary.

[5] Dunstan Allison-Hope and Guy Morgan, "Navigating the Materiality Muddle," BSR blog, August 13, 2013, https://www.bsr.org/en/our-insights/blog-view/navigating-the-materiality-muddle.

[6] Natsha Buckley, "The Limited Partners' Responsible Investment Due Diligence Questionnaire and How To Use It," PRI, November 25, 2015, https://www.unpri.org/download?ac=262.

A policy ought to, at a minimum, comprise the following dimensions (which incorporate the focus on material issues). Below is a list of dimensions and tips to embed the policy into the firm's architecture.

Table 2: Policy dimensions, their descriptions, and some considerations for illustrative content

Dimension	Description	Tips and Considerations
Title and approval date	Provide a clear title and the timeframe the policy was developed or updated.	Develop a title that is succinct and easily searchable online.
Purpose and priorities	Make an explicit commitment to responsible investment and incorporating ESG issues into the firm's investment analysis and decision-making processes. State clearly what the firm seeks to achieve by integrating ESG considerations into its investment strategy, whether it is to address LP interest, to manage risk, or to create value for portfolio companies, etc.	Reference any principles and regulations that may have influenced the policy such as the PRI's six principles, the American Investment Council's Responsible Investment Guidelines, the UN Global Compact's Ten Principles, etc. Some policies also highlight ways in which responsible investment objectives align with global efforts to achieve particular United Nations Sustainable Development Goals, or industry-specific good practice if the firm has a certain investment theme. For instance, if a firm chiefly invests in the apparel and manufacturing sector, it is good practice to align with the International Labor Organisation's Declaration on Fundamental Principles and Rights at Work, which safeguards workers on a range of egregious workplace issues, particularly in global supply chains.

Dimension	Description	Tips and Considerations
Scope	Provide information about the types of investments and asset classes covered by the policy.[7] It should also explain whether the policy applies to current investments or only to future investments and funds.	Consider including language describing the firm's approach to minority and/or non-control investments and global/regional business units etc. In those situations, the firm may need to adapt its engagement approach with portfolio companies commensurate with its level of influence.
Governance structure	Describe who has overall responsibility for the policy and its implementation. This should include the responsible functions (for example, an ESG officer and a cross-functional committee) as well as the roles of team members (e.g. investment professionals and operational efficiency teams) who are responsible for day-to-day implementation across the investment lifecycle. Some policies include responsibilities for regional teams and boards of directors of portfolio companies.	Determine who has ultimate ownership for integration of ESG considerations into investment decisions. It may be useful to apply the Responsible, Accountable, Consulted, and Informed framework (or similar) to define the responsibilities of the different functions. Note that we recommend providing job/functional titles rather than the names of individuals, thereby avoiding the need to update the policy whenever personnel shift.

[7] The UNPRI's Reporting Framework for signatories requires that signatories have a policy in place that sets the overall approach to responsible investment and covers more than 50 percent of the firm's assets under management (AUM).

Dimension	Description	Tips and Considerations
Implementation approach	Broadly explain how the firm will implement its commitment across the investment lifecycle, both pre- and post-investment.	Pre-investment due diligence: » Describe at a high-level how investment teams will examine ESG issues in screening, diligence, and the Investment Committee Process. The policy may also include an exclusions list, i.e. a description of the types of investments that the firm will not make due to products and services that have potential negative impacts on society and the environment (e.g. tobacco, firearms, etc.). Post-investment and management: » Explain how the firm will monitor ESG risks and value creation opportunities in the portfolio, set ESG expectations for portfolio companies, monitor progress in meeting those expectations, and support portfolio companies in achieving them. » Note that success is particularly dependent on setting clear expectations for portfolio companies on improving their ESG performance.

Dimension	Description	Tips and Considerations
Reporting	Describe the firm's plans for reporting on its ESG practices and implementation of the policy to investors and/or other stakeholders, as well as noting the frequency and format for the reporting.	There are several potential avenues for external reporting. The options listed below are a combination of voluntary and mandatory reporting, depending on the desired degree of transparency and whether the firm is a signatory of the PRI. » Responding to individual investor queries, the format of which may have been agreed through a side letter provision relating to ESG issues. » Reporting publicly on progress via an external report or on the firm's website. » Reporting annually on the firm's responsible investment activities in alignment with reporting frameworks such as the PRI Reporting Framework and the Limited Partner Due Diligence Questionnaire[8].
Regular revisions of the policy	Commit to updating the policy to address evolutions in the firm profile, external best practices, and relevant regional/global legislation.	Revise the policy regularly to align with changes in in the firm's growth and investment strategy, business drivers, expanding asset classes beyond private equity, increasing investor demands, and emerging themes such as impact investing. It is considered best practice for each update to be dated and to seek senior level sign-off.

[8] PRI signatories are required to report on their responsible investment activities through the PRI's reporting tool annually.

Dimension	Description	Tips and Considerations
External collaboration (optional)	Consider illustrating the firm's commitments to unique external programs and highlighting any industry initiatives or multistakeholder forums relating to specific issues in which the firm is involved.	For instance, a group of French private equity firms united to form the iC20[9] and make a commitment to limit global warming to two degrees Celsius and reduce the GHG emissions of their portfolio companies. This initiative was recently endorsed by the PRI.

Some firms also develop accompanying information or documentation to provide more tactical detail on how a policy will be operationalized. This documentation may be useful in replying to LP interests or directing internal efforts, though because it is more oriented toward implementation and subject to change, it may be better to keep this separate from the formal policy. Areas covered by these documents might include the sources of ESG information used to evaluate investment decisions, guidance on metrics in evaluating investments, perspectives on ownership rights such as shareholder votes and board seats, and details on how the firm engages with portfolio companies.

What Comes Next?

Once the policy is finalized, the firm must act to implement and uphold the policy. This is where the rubber meets the road for embedding ESG considerations into firm practices and the investment lifecycle. Important next steps include:

» **Developing an implementation plan:** Create a succinct, pragmatic action plan so that the firm lives up to the commitments in its policy and can demonstrate progress to its stakeholders. This might include integrating ESG into diligence, developing portfolio-wide KPIs, creating post-investment portfolio improvement plans, reporting externally, etc.

» **Ensuring effective governance structures:** Seek greater accountability and develop individual resources at the firm for upholding the policy and implementing the plan.

» **Communicating the policy to appropriate stakeholders:** Make the policy publicly available and explain stakeholders' commitment to responsible investing with relevant parties such as LPs and the public.

» **Training investment professionals on the policy and its relevance to their functions:** Conduct training to explain the fundamentals of responsible investing, the firm's policies and principles, integration of ESG factors in the investment process, and what the role of team members is in applying and

[9] "PRI Endorses French Private Equity Initiative ic20 at Climate Finance Day," PRI, December 3, 2018, https://www.unpri.org/news-and-press/pri-endorses-french-private-equity-initiative-ic20-at-climate-finance-day/3862.article.

supporting the policy. Consider keeping records of those who attend trainings so you can indicate to LPs the extent of your training.

- **Taking action and measuring results:** Based on the policy and integration plans, take action to enhance portfolio performance and deliver long-term sustainable value. Use KPIs or performance measurement tools to demonstrate those improvements in financial and ESG outcomes and use clear examples to show the value of your interventions.

Conclusion

Resource scarcity, climate change, increased regulation on ESG issues, radical technology innovation, evolving attitudes on digital rights, employee activism—trends such as these are combining with a new age of transparency and the power of social media to make ESG management crucial.[10] Institutional investors (and their own stakeholders) have recognized the potential impacts of these developments and are asking GPs to respond accordingly. A pragmatic, meaningful policy is essential for a GP to declare its commitment to responsible investing and describe how it will follow through.

We hope this paper will provide firms a blueprint to write policies that align with their unique investment principles and strategies. We also welcome feedback, dialogue, and questions—about the paper or related topics. Most importantly, we look forward to continued collaboration with asset owners, investors, industry groups, and other stakeholders to shape the field of responsible investing to create sustainable long-term value.

[10] Linda-Eling Lee and Matt Moscardi, "2019 ESG Trends to Watch," MSCI, January 2019, https://www.msci.com/documents/10199/239004/MSCI-2019-ESG-Trends-to-Watch.pdf.

Additional Resources

1. **UNPRI Principles for Responsible Investment Resources for Private Equity:** https://www.unpri.org/investor-tools/private-equity

2. **Integrating ESG in Private Equity: A Guide for General Partners:** https://www.unpri.org/download?ac=252

3. **Incorporating Responsible Investment Requirements into Private Equity Fund Terms:** https://www.unpri.org/download?ac=271

4. **Institutional Limited Partners Association:** https://ilpa.org/due-diligence-questionnaire/

5. **Limited Partners' Responsible Investment Due Diligence Questionnaire:** https://www.unpri.org/download?ac=267

6. **Invest Europe's ESG DDQ for Private Equity Investors and Their Portfolio Companies:** https://www.investeurope.eu/about-us/responsible-investment/esg-ddq/

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About BSR

BSR is a global nonprofit organization that works with its network of more than 250 member companies and other partners to build a just and sustainable world. From its offices in Asia, Europe, and North America, BSR develops sustainable business strategies and solutions through consulting, research, and cross-sector collaboration. Visit www.bsr.org for more information about BSR's 25 years of leadership in sustainability.

About BSR's Work in Alternative Assets

For a decade, BSR has worked with asset owners and alternative asset management firms to advance their responsible investing efforts and integrate ESG throughout their investment practices. We combine our experience across asset classes (including private equity, infrastructure, and private credit) with in-depth expertise across sectors and geographies to develop pragmatic, strategic solutions. Collaborating with organizations at all levels of maturity, BSR helps firms build their first responsible investment programs; supports experienced firms in creating more in-depth, advanced practices; and partners with leaders to pioneer innovative, high-impact initiatives. We also work with portfolio companies directly to enhance their sustainability. We seek to uphold BSR's mission by further integrating ESG considerations into financial markets, by promoting sustainable practices, and by encouraging the deployment of capital that advances solutions to the world's most pressing problems.

Contact Information

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