Private Equity for the Public Interest: The Evolution of ESG and Considerations for Asset Managers and Investors
Introduction

Since the establishment of the UN’s World Commission on Environment and Development, sustainable development has been gaining momentum in the private equity (PE) industry. Sustainable development refers to development that meets the economic and social needs of the present without compromising the ability of future generations to meet their own economic and social goals.

The acceptance and spread of the sustainability concept globally has led to the development of new laws, regulations, industry standards and policies, and has even prompted the creation of new investment products such as green bonds and green loans. In the PE industry, the desire to embrace sustainability has led to an increase in firms and funds coming to the market that are dedicated to addressing the environmental or social aspects of sustainable development in their investment processes. For traditional PE firms, responsible investing has become more of a stated priority for the investment decision-making process of both PE sponsors (i.e., general partners (GPs)) and their investors (i.e., limited partners (LPs)).
What is ESG?

ESG covers a broad array of issues and considerations but generally refers to three central factors – environmental, social and governance principles – which are applied to gauge the sustainability and ethical impact of an investment in a company or business.

Many of these issues are interconnected and often situation-specific. For more information on the social aspect of ESG please see our in-depth summary: Understanding the “S” in ESG: Guidance for Asset Managers and Investors in a COVID-19 Paradigm and Beyond.
The State of ESG Adoption Around the World

PE firms are increasingly factoring ESG principles into their investment decisions and portfolio management strategies at all stages of the deal cycle. In many cases, they are following the lead of their LPs: according to a 2019 survey by UBS of over 600 asset owners in 46 countries, 78 percent of LPs are already integrating ESG principles into their investment processes.¹ This high level of LP demand is now pushing PE sponsors to respond with their own ESG initiatives.

The incorporation of ESG into investment decisions is already fairly common in Europe and North America, with 1,475 asset owners and investment managers across Europe, and 695 in North America, signed up to the UN’s Principles for Responsible Investment (PRI) as of June 2020.² Africa and Asia generally lag behind Europe and North America despite the importance of ESG analysis in developing countries, which may

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Commitment to ESG: Signatories to the PRI

![Diagram showing the commitment of asset owners and fund managers to the PRI in different regions.](image-url)

Read more about the PRI on Page 6.
have limited resources to mitigate or adapt to unique problems like agricultural production swings, food price volatility and the anticipated effects of climate change. According to a report published by Bain & Company, only 13 percent of Asian investors have completely integrated ESG principles into their investment decisions or taken concrete actions to improve the ESG performance of their portfolio companies.3

Over the last decade, however, the drive and pressure from investors in Asia to incorporate ESG factors into investment analysis is increasing4 and PE sponsors are responding, as evidenced by a 15 percent increase between 2018 and 2019 in Asian fund managers who have signed up to the PRI. In absolute numbers, as of June 2020, over 375 asset owners and investment fund managers in Asia have signed the PRI. Work remains to be done in Africa, where only 76 African asset owners and investment fund managers had signed the PRI by the same date, with the majority based in South Africa.

Source: UN PRI figures and data
What are the Principles for Responsible Investment?5

PRI signatories include investment managers, asset owners6 and providers of investment services.

All signatories pledge to:

• incorporate ESG issues into investment analysis and decision-making processes;
• be active owners and incorporate ESG issues into their ownership policies and practices;
• seek appropriate disclosure on ESG issues by the entities in which they invest;
• promote acceptance and implementation of the PRI within the investment industry;
• work together to enhance the group’s effectiveness in implementing the PRI; and
• report on their activities and progress towards implementing the PRI.
Factors Driving ESG in Private Equity

CORPORATE GOVERNANCE

Of the three types of ESG issues, corporate governance issues tend to be most easily integrated into investment analyses. This is particularly true in more developed European and North American markets, where company directors and managers have been subject to clearly defined and well-enforced fiduciary duty requirements and other corporate governance regulations for decades.

In Asia, the Asian Development Bank identified poor corporate governance as a key weakness in a number of economies as recently as the Asian financial crisis of the late 1990s. Since then, certain regulators in the region have strengthened corporate governance practices by introducing and enacting principles, codes and regulations relating to fiduciary duties for directors, among other initiatives. Malaysia recently amended its Code of Corporate Governance to enable all listed companies to comply on an “apply-or-explain” basis (i.e., companies must comply or explain how they have otherwise applied the principles set out therein), whereas Singapore amended its Code of Corporate Governance to permit compliance on a “comply-or-explain” basis (i.e., companies may either comply or explain why they do not). The Hong Kong Stock Exchange (HKEx) incorporated the “comply-or-explain” concept with respect to all types of ESG disclosures, including corporate governance, in 2015. However, given the diversified mix of economies across Asia, there are different standards of corporate governance throughout the region. Generally, higher GDP per capita countries such as Australia and Singapore tend to score higher on corporate governance metrics than developing economies such as Indonesia and Malaysia.

In Africa, corporate governance issues tend to dominate the bulk of discussions around ESG. Of course, corporate governance regimes vary from country to country. The most progressive African country in this regard is South Africa, where the Institute of Directors in Southern Africa established the King Committee on Corporate Governance in 1993. The Committee issues the King Reports on Corporate Governance, which is a set of voluntary “comply-or-explain”-based corporate governance codes. In addition, the Code for Responsible Investing in South Africa is a best-practice governance framework for institutional investors with an “apply-or-explain” approach, while companies listed on the Johannesburg Stock Exchange must address ESG factors in annual reports. In Nigeria, various industry codes regulate corporate governance matters, including the Financial Reporting Council’s Code of Corporate Governance 2018 and the Securities and Exchange Commission Rules 2013.

The US has some of the world’s most stringent corporate governance regulations, including the well-known Sarbanes-Oxley Act and Dodd-Frank Act, which were born out of the 2001/02 recession and the 2007/08 financial crisis, respectively. These laws give the federal government increased oversight over the governance of US-based public companies, particularly financial institutions, and may apply to private companies or foreign companies with US-registered equity or debt securities. Mandatory governance-related disclosures are commonplace in the US, in contrast to the “comply-or-explain” basis more common in European jurisdictions.

In addition to government regulation at the federal and state level, the US investment community has issued a number of corporate governance guidelines that are increasingly influential, including the “Policies on Corporate Governance” issued by the Council of Institutional Investors (CII). The CII is a group of 135 public, union and corporate employee benefit plans, endowments and foundations representing approximately US$4 trillion in AUM. Similarly, the Investor Stewardship Group, a group of US-based institutional investors and global asset managers representing more than US$20 trillion in AUM, issued the “Corporate Governance Principles for US Listed Companies” and “Stewardship Principles” in 2017. Market participants in a range of industries are turning to these and other policies and principles for guidance on corporate governance matters and best practices.
CROSS-BORDER INVESTORS AND DFIS

The rise of ESG within the PE industry, particularly in Asia and Africa, has been driven in part by cross-border investors and international policy as investors around the world are becoming cognizant of the fact that competitive financial returns can be generated alongside social benefits. For example, the US$1 trillion Government Pension Fund of Norway, the world’s largest sovereign wealth fund, has divested from 33 palm oil firms over deforestation concerns. Further, a recent survey conducted by PwC shows that a majority of PE investors in general (76 percent) are concerned about the impact of human rights issues at the portfolio company level. Accordingly, we have seen more PE firms respond to these concerns by adopting human rights policies and integrating human rights risk management procedures into their investment processes. These issues are particularly salient for firms with cross-border investment strategies encompassing regions where human rights abuses are more common.

Development finance institutions (DFIs), such as the International Finance Corporation (IFC), FinnFund, Proparco, Financierings-Maatschappij voor Ontwikkelingslanden N.V. (FMO), Norfund and CDC Group (CDC), play a key role in supporting first-time fund managers in emerging markets. These DFIs have played an important part in promoting the uptake of sustainable financing, particularly in Asia and Africa, by requiring the integration of ESG factors into the investment decision-making process, as well as ongoing ESG management and reporting, as a prerequisite for their investment. As a result, the PE industry in Africa is credited with having some of the world’s best ESG practices.

Investment Exclusions

DFIs also influence the investment strategies of PE firms through their exclusion of certain investments. Sustainable investors, including DFIs, typically seek to exclude or restrict investments in producers or distributors in the following industries:

- TOBACCO
- COAL
- PALM OIL
- ALCOHOL
- WEAPONS
- GAMBLING

Exclusionary strategies are becoming a popular form of ESG integration among DFIs. Since January 2013, at least 100 financial institutions have divested from thermal coal and, of these, 12 of the top DFIs have announced restrictions on financing for coal.
INCREASED RETURNS
Evidence suggests that companies that effectively manage ESG considerations face lower costs of capital (i.e., a lower cost of borrowing in bond or equity markets) and a lower risk premium due to greater transparency. According to a global survey of institutional investors conducted in 2015, 57 percent of the respondents supported the notion that integrating ESG into investment processes has a positive impact on risk returns and helps portfolio companies become sustainable.18

Some studies have directly supported this notion. For example, a survey conducted by Deutsche Bank in 2012 found that companies with high ESG performance typically outperform the market. 19 Furthermore, an analysis of the MSCI All Country World index between 2007 and 2018 conducted by Lyxor Asset Management found that excluding companies with low ESG scores did not impact fund performance negatively and, in most cases, improved performance on a risk-adjusted basis.20

RISK MITIGATION
In a global economy dependent on cross-border trade, companies and their supply chains are increasingly confronted with environmental risks such as climate change, water scarcity and pollution. In addition, social risks including product safety and relationships with employees, regulators and other stakeholders in the communities in which businesses operate are becoming more prevalent. Accordingly, firms are more often seeking to apply ESG principles in their investment decision-making processes to mitigate the risk of these external issues. Both GPs and LPs cited risk management as the prime driver for responsible investment activity in a 2019 PwC report,21 while approximately three quarters of institutional investors stated that risk mitigation was the main driver for their increased interest in ESG in a 2017 report by Swiss Re.22

In these respects, the COVID-19 pandemic, which has devastated supply chains and exacerbated existing social problems like income inequality, presents the first significant test for many ESG portfolios. Initial data suggests that ESG funds are passing that test and meeting investor expectations as to risk mitigation—ESG funds mostly generated above average returns when compared to the S&P 500 during the crisis, with more than 70% of ESG funds across all asset classes generating returns greater than their counterparts through the first four months of 2020.23 It remains to be seen, however, if this resilience will continue as the pandemic drags on.

LOCAL REGULATIONS
Europe
In 2015, France became the first country to introduce mandatory climate change reporting for institutional investors.24 Under Article 173 of LOI n° 2015-992 du 17 août 2015 relative à la transition énergétique pour la croissance verte, a wide range of investors including asset managers, insurance companies, and pension funds are required to report how they integrate ESG factors into their investment policies and risk management processes on a “comply-or-explain” basis. Article 173 specifically encourages investors to measure their portfolios’ carbon footprints, which has led investors to decarbonize portfolios by directing capital away from carbon-intensive companies.

In March 2018, the European Commission unveiled its Action Plan on Sustainable Finance.25 The plan includes various proposals to drive sustainability in the EU, including by developing low-carbon benchmarks and a comprehensive classification system for investors to identify environmentally sustainable economic activities. There has since been a flurry of EU legislative activity aimed at integrating ESG risks into investment and advisory processes and communicating the positive impact that ESG integration can have on returns and profitability. Recent developments include:

- The publication of the “Disclosure Regulation” on 27 November 2019.26 The Disclosure Regulation sets out harmonised rules for market participants with regard to the integration of sustainability risks and adverse sustainability impacts into their disclosure processes, among other things. The Disclosure Regulation will take effect on 10 March 2021.
- The development of “The European Green Deal”, announced on 11 December 2019,27 which provides a roadmap for the EU to restore biodiversity, cut pollution and boost the efficient use of resources by moving toward a clean, circular economy. In connection with the Green Deal, the EC presented a “European Green Deal Investment Plan” on 14 January 2020,28 which will mobilise EU funding to facilitate investments to transition to a climate-neutral, green,
International Efforts

In addition to local regulations, various voluntary and/or mandatory international initiatives may apply to certain industries, or with respect to specific ESG factors. For example:

The Carbon Offsetting and Reduction Scheme for International Aviation (CORSIA) is an emission mitigation approach for the global airline industry.

RE100 is a global corporate leadership initiative working to increase corporate demand for, and supply of, renewable energy.

The Oil and Gas Climate Initiative is an international industry organization committed to accelerate the reduction of greenhouse gases in support of the Paris Agreement.
competitive and inclusive economy, and on 4 March 2020 proposed a European climate law to establish a framework for the EU to meet its goal to become climate-neutral by 2050.29

• The EU Parliament’s adoption of the “Taxonomy Regulation” on 18 June 2020.30 The Taxonomy Regulation will harmonise the criteria for determining whether an economic activity qualifies as environmentally sustainable at the EU level.

Future developments at the EU-level will include the introduction of legislation that will require companies to carry out mandatory human rights and environmental due diligence, as set out in a 29 April 2020 communication from the European Commissioner for Justice.31 The legislation is currently being developed, but the Commissioner has suggested that it will contain an enforcement mechanism with sanctions. This legislation will be introduced by 2021. Separately, the German Labour Minister has announced that he will table a bill in August 2020 that would hold companies accountable for “foreseeable and thus preventable violations” of human rights standards in their supply chains.32 Market participants around the world can expect the development of similar legislation aimed at tackling human rights issues in due diligence and throughout the supply chain, as a paper issued by the UN Office of the High Commissioner on Human Rights in June 2020 recognizes a growing trend toward the implementation of these regimes.33

In addition, the European Securities & Markets Authority (ESMA) has recommended amending relevant requirements to request certain funds management companies and funds to consider sustainability risks in their internal systems, controls and due diligence processes. ESMA has also provided technical sustainability advice on the Markets in Financial Instruments Directive 2004/39/EC, noting that investment firms should be required to consider sustainability risks in their risk management policies and procedures.34

In 2016, the UK Pensions Regulator published a Code of Practice for defined contribution schemes that requires trustees to develop a statement of principles including details on ESG matters and sustainability.35 Further, in September 2019, regulations came into force requiring pension fund trustees to carry out ESG risk assessments and provide their members with details on how they account for ESG and climate change considerations in investment decision making.36

In addition to these regulatory requirements, there are a number of voluntary market codes and other initiatives relating to ESG that are relevant to certain sectors of the asset management community. In July 2019, over a third of listed companies in Switzerland volunteered to commit to more comprehensive sustainability reporting, providing investors with specific metrics in line with international “best practice” guidelines from institutions including the Global Reporting Initiative, the Sustainability Accounting Standard Board, the UN Global Compact and the European Public Real Estate Association.37 In the UK, asset managers often look to the PRI and the UK Corporate Governance Code, among other voluntary codes, for guidance on ESG matters.

Court decisions have further prompted PE firms to consider ESG issues in their decision-making processes. For example, the recent UK case of Vedanta Resources PLC v. Lungowe expanded the duty of care applicable to PE firms by making them liable for the acts of their portfolio companies in certain circumstances.38 The case involved claims brought by Zambian farmers against a UK mining company and its Zambian subsidiary in relation to environmental damage. As a result, we have observed an increase in PE firms reviewing their own human rights and sustainability policies, as well as those of their portfolio companies.

In a sign of things to come, and as discussions on climate change continue to dominate headlines, both Christine Lagarde, President of the European Central Bank, and Mark Carney, former Governor of the Bank of England, have intimated the use of monetary policies and supervision to fight climate change. The European Central Bank announced its intention to make climate change “mission critical” in 2019,39 while the Bank of England has announced plans to incorporate climate stress testing for its largest banks and insurers beginning in 2021.40
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North America

The US and Canada are in the midst of a sustained regulatory push on various ESG matters, while regulators in Mexico appear less focused on these issues. At a high level, in the US there has been a divergence of approach to ESG reporting from Europe since July 2019, when the US Congress rejected proposals that would have aligned certain US ESG reporting requirements with more rigorous standards in Europe.41

Notwithstanding this development, the US Securities and Exchange Commission (SEC) has proposed changes to Regulation S that would require businesses to disclose in their descriptions of risk factors “human capital measures or objectives that management focuses on in managing the business”, among other things.42 Additionally, the SEC’s Investor Advisory Committee, a body comprised of market participants that advises the SEC on various regulatory matters, is pushing the SEC to go further by recommending the promulgation of specific disclosure policies regarding ESG topics for registered issuers.43 The SEC has yet to determine whether to proceed with this suggestion.

In another sign of potentially stronger disclosure measures to come, two former leading candidates for President of the United States, Senators Elizabeth Warren and Bernie Sanders, have urged financial institutions including BlackRock, JP Morgan Chase, Vanguard and Fidelity to publicly disclose how they manage investments in the palm oil industry, citing deforestation concerns.44 If these initiatives take hold, the US could borrow from the Canadian social disclosure regime, in which public companies have been required to disclose diversity information with respect to certain “designated groups” since January 2020.45

Meanwhile, senior business leaders in the US are pushing for changes to a well-established corporate governance principle that could facilitate a global shift toward sustainable business practices, including ESG integration. In an August 2019 statement, the Business Roundtable (a group of 181 CEOs) directly challenged the decades-old concept of shareholder primacy, in which “the social responsibility of business is to increase its profits”, by making a commitment to deliver value to all stakeholders rather than to shareholders alone.47 The group, which includes the CEOs of many of the world’s largest companies, has committed to serve the interests of customers, employees, suppliers and communities, including by providing fair compensation for employees, dealing ethically with suppliers and protecting the environment.

As the US emerges from the COVID-19 pandemic, and the widespread calls for racial justice that emerged in mid-2020 evolve from street protests into concrete policy changes, it seems likely that this idea for a more inclusive capitalism will find broad support among the American public. In Canada, the notion took hold in 2019 when the legislature amended the Canada Business Corporations Act (CBCA) to expand the scope of constituents that directors are permitted to consider in discharging their duties.48 Directors may now consider the interests of employees, retirees, pensioners, creditors, consumers and governments, as well as the environment, in addition to the traditional interests of shareholders. While the amendment generally served to codify existing case law, the move suggests broad support for ESG regulation within the Canadian government.

Although this idea is generally in line with global trends toward sustainability, it is not without its critics. The CII has expressed concern that the Business Roundtable statement “undercuts notions of managerial accountability to shareholders.”49 In the CII’s view, a company’s “accountability to everyone means accountability to no one” and, ultimately, “it is the government, not companies, that should shoulder the responsibility of defining and addressing societal objectives with limited or no connection to long-term shareholder value.”50

A similar position was recently taken by the US Department of Labor, which has proposed amendments to a federal law that could prevent certain US pension plans from participating in sustainable investments on the basis that ESG considerations are adverse to the creation of investment value.51 According to the Secretary of Labor, “private employer-sponsored retirement plans are not vehicles for furthering social goals or policy objectives that are not in the financial interest of the plan.”52

As companies, investors and others entrench themselves on different sides of this debate, it may ultimately be left to American legislators or courts to decide whether companies should adopt the ideas of the Business Roundtable and the Secretary of Labor described above. Should they codify these principles into American corporate law, more jurisdictions around the world may follow suit.
Asia

Like their counterparts in Europe and North America, Asian governments are requiring regular reporting on ESG-related matters, particularly for listed companies. For example, entities listed on the Singapore Stock Exchange are required to prepare an annual sustainability report that describes the organisation’s sustainability practices with reference to ESG issues. Similarly, Bursa Malaysia requires listed issuers to include a sustainability statement in their annual reports covering the management of material economic, environmental and social risks and opportunities. Similar disclosures are also required for listed entities in Hong Kong and Vietnam.

Hong Kong has taken a particularly comprehensive approach to ESG disclosures, evidenced by the establishment in May 2020 of a Green and Sustainable Finance Cross-Agency Steering Group consisting of the Hong Kong Monetary Authority, Securities and Futures Commission (SFC), HKEx and four other government agencies. Going forward, the members of the Steering Group will coordinate on the development of sustainable finance regulation in Hong Kong.

In recent years, the HKEx has instituted a fulsome ESG reporting regime for listed companies and published several reporting guides to help navigate these regulations. HKEx-listed companies are required to disclose a range of ESG information, from general disclosures regarding policies on emissions and employment practices to specific disclosure of tons of greenhouse gases emitted annually and employee turnover rate by gender. A 2018 study suggests that listed companies are slowly adjusting to these rules and incorporating ESG requirements into their financial reports, with 78 percent of listed companies disclosing at least some of these key ESG performance indicators as required by HKEx – but only 11 percent of listed companies are fully compliant. Importantly, the HKEx has shown a willingness to refine and continually develop its ESG rules with input from the market, which could help improve compliance rates, including by conducting a comprehensive review of its ESG Reporting Guide in 2019. The results of this review were published in December 2019, and related amendments to the local reporting regime will take effect on 1 July 2020. Among other things, the amendments address both the social and governance aspects of ESG by requiring the
disclosure of new health and safety data, as well as information about the board’s role in overseeing ESG issues.

The HKEx entered a new phase in its commitment to ESG in June 2020 by partnering with various international organizations, including the Climate Bonds Initiative and International Capital Market Association, to launch its Sustainable and Green Exchange (STAGE). STAGE is an information platform that will, initially, host a repository of information on green bond issuances. In the future, STAGE will expand its coverage to include more products, such as ESG-linked derivatives, and provide investors with access to information for the due diligence, selection and monitoring of sustainable and green investments.

The SFC is also taking steps tailored specifically to asset managers and investors. In December 2019, the regulator published the results of a survey of 794 asset managers and 14 asset owners on their current perspectives and practices regarding ESG and climate change. The results set out a number of common industry practices ranging from the implementation of board-approved ESG policies to investment-screening strategies, as well as areas of improvement for asset managers based on asset owners’ responses.

In November 2019, the Securities Commission Malaysia released the Sustainable and Responsible Investment (SRI) Roadmap for the Malaysian capital markets, which is intended to create an SRI ecosystem and chart the role of the capital markets in driving sustainable development.

On the topic of climate change, Singapore is leading the charge in Southeast Asia and, in 2018, passed the Carbon Pricing Act, which imposes a carbon tax on facilities that emit 25,000 tCO2e (tons of carbon dioxide equivalent) or more of greenhouse gases annually. The carbon tax will apply to power stations and other large direct emitters of pollution, and will give these entities the option to either reduce their emissions or pay the carbon tax. More recently, in June 2020 the Monetary Authority of Singapore launched public consultations on new Guidelines for Environmental Risk Management, which will set out sound practices in relation to the governance, risk management and disclosure of environmental risks for banks, insurers and asset managers.

Africa

Few countries within the continent have enacted mandatory ESG reporting or integration requirements. ESG reporting requirements typically take the form of voluntary industry guidance or codes like the Capital Markets Authority of Kenya’s Stewardship and Corporate Governance Codes, which encourage institutional investors to incorporate social, environmental and ethical concerns into their investment processes. In 2016, the Nairobi Stock Exchange (NSE) announced that it would launch Kenya’s first sustainability index to measure listed companies’ ESG practices. However, as of early 2020 the NSE had not yet put in place written guidance on ESG reporting, nor had it launched the sustainability index. In 2019, the Nigerian Stock Exchange issued the Sustainability Disclosure Guidelines, which set out recommended practices in 13 thematic areas under four core principles for ESG reporting. The guidelines are intended to promote a consistent approach to ESG reporting among issuers listed on the Nigerian Stock Exchange.

One notable exception is in South Africa, where the Pension Funds Act provides that retirement funds should consider ESG factors that may impact the long-term performance of a fund’s assets. On 22 January 2019, the Nigerian House of Representatives passed the “Act to Repeal the Companies and Allied Matters Act 1990 and enact the Companies and Allied Matters Act 2018”, which is intended to improve the country’s corporate governance practices, among other things.

We note that the African PE industry is still in the relatively early stages of development, particularly in Sub-Saharan Africa. Accordingly, as the industry grows we expect that a combination of investor demand and the rise of green financing, in the form of green bonds and loans, will continue to push regulators on the continent to address ESG issues in the near term.
Considerations for PE Sponsors and Investors

The data clearly shows that many asset managers have already incorporated ESG into their investment activities and operational processes in response to a variety of factors, ranging from ESG-related government regulation and investor expectations or requirements to financial data indicating that it may increase returns. The question for asset managers that lag in their adoption of ESG-related protocols, then, is not if they should consider ESG issues at all, but whether they should proactively incorporate ESG principles into their ecosystems (i.e., a supply side-driven approach) or wait to address investors' ESG-related concerns as and when they come up (i.e., a demand side-driven approach).

Recent activity suggests that investors inevitably will demand attention to ESG issues. A 2019 survey of 101 institutional investors across private equity, private real estate, infrastructure and private credit sectors found that approximately 85 percent of LPs now consider ESG issues when conducting fund due diligence and, for approximately 40 percent of LPs, it is a ‘major consideration’.65 This sentiment is particularly widespread in emerging markets: a 2019 survey of 104 LPs found that 91 percent considered an emerging market private equity sponsor’s active management of, and reporting on, ESG criteria to be at least ‘somewhat important’ when selecting a manager. That same study found that 69 percent of LPs expected formal ESG reporting from emerging markets sponsors on at least an annual basis.

We have observed that more PE sponsors in Asia and Europe are proactively addressing their investors’ growing concerns regarding ESG matters by adopting some or all of the following measures:

i. **Identifying suitable proposed investments** – PE sponsors typically, prior to investing in any portfolio company, investigate public domain information regarding any adverse impacts on local communities or the environment, or adverse environmental or social performance associated with that portfolio company. PE sponsors would invest in such company on the condition that its management resolves all identified adverse impacts or performance in accordance with the sponsors’ ESG requirements, or that the company agrees to an ESG action plan to resolve the identified adverse impacts or performance within a reasonable timeframe. Alternatively, certain sponsors may only invest in entities that maintain exemplary ESG credentials or by impact investing, which involves investing in projects with a direct environmental or social purpose that also provide a financial return. [See “Making a Difference: A Spectrum of Approaches to Investing”]

### MAKING A DIFFERENCE: A SPECTRUM OF INVESTMENT APPROACHES

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<td>Incorporates some ESG principles into traditional investment analysis in order to maximize financial returns</td>
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ii. **Monitoring and reporting** – It is becoming more common for PE sponsors to incorporate ESG monitoring and reporting requirements in the constitutive documents of their private-fund vehicles. In the case of a fund established as a limited partnership, the constitutive limited partnership agreement (LPA) may entitle members of the advisory committee representing LPs (or ESG consultants appointed by such members) to visit any of the premises where a portfolio company’s business is conducted, to have access to such company’s management, and to examine the books and records of the company as needed. The LPA may also require the GP to report to the LPs, at regular intervals, qualitative or quantitative ESG metrics with respect to the fund’s portfolio companies.

iii. **Tailoring investment allocation according to makeup of their LP base** – PE sponsors can employ fund structures or terms that ensure that those LPs that are concerned with particular ESG issues are directed to investment opportunities that align with their views. Sponsors can preempt investors’ concerns most effectively and definitively in the fund terms, either by including ESG provisions in their draft fund documents or being prepared to consider, and constructively respond to, LP requests for inclusion of such provisions before the parties reach the negotiating table.

In any event, when preparing a new fund’s term sheet or constitutive document, sponsors should consider the PRI’s suggestions for incorporating four categories of ESG principles:

- **Commitments to Policies, Standards and Regulation**: Certain investors may require the sponsor to comply with an external standard, such as the principles of the UN’s Global Compact or the IFC’s Environmental and Social Performance Standards, or seek assurance that the sponsor has a long-term commitment to its own responsible investment policy and its continual improvement. Investors may wish to be consulted on any material revisions to the sponsor’s responsible investment policy, either individually or through a meeting of an advisory board or, as applicable, an LP advisory committee (LPAC).

- **Investment Restrictions and Limitations; Exercise of Remedies**: The constitutive documents should disclose any of the sponsor’s own ESG-related investment restrictions. Investors may require additional “negative screening” restrictions or a prescribed list of excluded activities that could preclude a fund from investing in (i) individual companies, (ii) companies engaged in certain activities and/or (iii) securities associated with certain countries. The constitutive documents should also include appropriate remedies, including rights to be excused from any of the portfolio investments of a fund, if such investment falls within the negative screening categories or excluded activities. Investors would often seek such an “excuse right” to avoid a conflict between the negative screening categories or excluded activities with the GP’s own investment strategy, which often cannot be modified.

- **Investment Process and Decision Making**: If a sponsor does not have an investment policy that explains how ESG issues will factor into investment decisions, investors may require the sponsor to include this information in a fund’s placement memorandum, LPA and/or other constitutive document. Provisions that could be incorporated into the investment documentation may require the sponsor to conduct an ESG assessment of a potential portfolio company during initial due diligence, require all portfolio companies to adhere to specified ESG standards and/or conduct a fund-wide ESG risk/opportunity screen.

- **Reporting**: Sponsors of private funds may be required to adhere to ongoing ESG reporting requirements by giving repeating representations on each drawdown notice that the fund is in full compliance with ESG policies. They may also be required to report ESG-related information in various ways, which include relevant updates in drawdown notices or the annual reports of the fund and/or portfolio companies to specific formats required by an investor, or as a required agenda item at regular meetings with the advisory board or, as applicable, LPAC. Investors might require reporting on specific ESG metrics, including updates on material changes to the sponsor’s responsible investment policies, demonstration of ESG integration in the due diligence process, analysis of ESG-related progress made by portfolio companies against prior goals or key performance indicators and analysis of material ESG risks or opportunities across the private fund’s portfolio.
What can a Responsible Investment Policy do?

A responsible investment policy can, at a minimum, give LPs some level of comfort that the sponsor is addressing ESG issues, particularly when investors are consulted during its drafting. Generally, a responsible investment policy may:

i. limit its application to “material” ESG issues (and define materiality);

ii. describe plans for reporting on ESG practices and investment policy implementation to investors;

iii. describe how investment professionals will integrate ESG criteria into pre-investment due diligence analysis; and/or

iv. set clear expectations in the form of measurable goals in specified timeframes for post-investment portfolio companies to improve ESG performance etc.

These suggestions are particularly important for PE sponsors negotiating investments with DFIs. A 2019 survey of 104 institutional investors, including 28 DFIs, found that each one of the DFIs required ESG-related language (which may include some or all of the suggestions above) in the fund’s constitutive documents as a prerequisite for investment. Only half of the non-DFI respondents required such language. The specific provisions that DFIs request may also prove particularly onerous for sponsors, as 65 percent of DFIs surveyed expected sponsors and/or other investors to produce quantitative metrics on ESG outcomes.

No matter how PE sponsors and other investment managers address investors’ ESG concerns, it is clear that practices are evolving rapidly and investment managers cannot simply remain static. Two ways that sponsors can act now are to (i) adopt a responsible investment policy and (ii) incorporate one or more ESG toolkits (see further below) into their existing investment processes. [See “What can a Responsible Investment Policy do?”]
To encourage the integration of ESG matters in the investment decision-making process, certain DFIs have produced ESG management and reporting guides for use by PE firms and their respective portfolio companies. For example, CDC has developed a free ESG risk-management toolkit that sponsors can access and build into their existing models. The toolkit provides, among other things, guidance on how to integrate ESG considerations into the investment cycle of a PE fund, information on how PE fund managers can design and implement ESG policies and procedures, an overview of selected environmental and social topics and advice on corporate governance and other business integrity issues.

The Challenges

The main hurdles to increased ESG integration within PE firms include:

- **Limited understanding of ESG issues**: Among investors worldwide, and principally in Asia and Africa, there remains a general lack of understanding of ESG issues (in particular, confusion as to the difference between Corporate Social Responsibility and ESG initiatives), and a lack of clarity on which ESG issues are material. This has caused some sponsors to struggle to properly translate ESG from a corporate perspective into an investor "materiality" perspective, whereas portfolio managers tend to have difficulty quantifying ESG issues. As a result, even if fund managers are frequently integrating ESG into the investment process, they are more rarely adjusting their models based on quantitative ESG data.

In addition, for some investors there may be insufficient evidence of the tangible investment benefits of integrating ESG into corporate culture. In such circumstances, there is a risk that adherence to various corporate codes or regulations becomes a “tick-the-box” exercise. This risk was apparent in the case of Singapore’s Hyflux Ltd, where the company far exceeded certain guidelines in Singapore’s Code of Corporate Governance but, in practice, did not fully embrace best practices for corporate governance.

- **Lack of comparable ESG data**: Investors acknowledge that the availability of ESG data has improved, but its quality and comparability remains unchanged. One way to integrate ESG into the market would be to apply ESG metrics to individual stocks and assign them a level of risk, which would affect their risk adjusted appeal. However, as there is no agreed-upon methodology for reporting on ESG matters in most jurisdictions, the data collection and reporting process is difficult. As ESG reporting is a relatively new field, there is a general scarcity of data, particularly from non-listed companies. Even where ESG toolkits from DFIs are used to collect and report data, questions remain regarding the quality of the data collected – a large amount is qualitative in nature and not comparable against specific metrics. This situation hampers any kind of modelling or back-testing of ESG factors. Agreement on a single ESG reporting standard that is acceptable to both companies and investors would help streamline the data-collection process and produce better quality, comparable data.

- **Regulators’ role**: In many jurisdictions, ESG reporting requirements apply to listed entities only—and even then, on a “comply-or-explain” basis—though there has been a move towards mandatory ESG integration and reporting in Europe and the United States. International bodies are also driving regulatory efforts around the world, as the UN has encouraged regulators, as a first step, to support the Sustainable Development Goals (SDGs) by addressing the five action areas identified in the UN Sustainable Stock Exchanges Initiative (the SSE Initiative). [See “What is the SSE Initiative?” on the next page.]

Further, the International Organization of Securities Commissions’ (IOSCO) Growth and Emerging Markets Committee (GEMC) initiated a project on the role of securities regulators with respect to sustainable finance in emerging markets. The project aims to help emerging markets regulators better understand the issues and challenges that affect the development of sustainable finance in capital markets. The GEMC has produced a list of recommendations that member jurisdictions should consider when issuing regulations or guidance regarding sustainable products and/or ESG disclosure requirements.
What is the SSE Initiative?

The SSE Initiative identifies five action areas where securities regulators can contribute to a more stable and resilient financial system that better supports the SDGs. These are:

1. **Facilitate investment to support the delivery of the SDGs**: Aid investment flows towards achieving the SDGs via financial products.

2. **Strengthen corporate sustainability-related disclosures**: Improve the quality and quantity of disclosure on environmental and social data.

3. **Clarify investor duties on sustainability**: Guide investors on the integration of sustainability into their decisions.

4. **Strengthen corporate governance to support sustainability**: Introduce board responsibilities related to environmental and social factors; and

5. **Build market capacity and expertise on sustainability**: Facilitate the training of market participants on sustainability topics.
It is an interesting time in the development of sustainable business practices globally as governments, investors and business leaders find new ways to address some of the world’s most pressing issues. Emerging markets in Asia and Africa have their own special challenges given their varied economies and diverse ESG issues, which demand a similarly diverse range of ESG-related responses. To some degree, governments in these regions are emulating regulatory regimes in Europe and North America, which are generally more advanced in terms of promoting ESG reporting and policing of offenders. Similarly, international investors are exerting their influence and promoting sustainable business practices, including ESG integration, throughout the world.

For PE sponsors, this trend toward ESG integration presents both challenges and opportunities. While sponsors may have some difficulty integrating new ESG factors into existing investment processes, the ability to show investors (with an increasing focus on sustainability) a serious and dedicated approach to ESG issues may well attract new business. Thankfully, sponsors already have numerous ESG-related options available. At one end of the spectrum, sponsors may choose to integrate a few ESG factors into their due diligence and investment analysis processes. Going further, sponsors may adopt robust ESG monitoring and reporting regimes, at the fund or portfolio company level, or even raise funds solely focused on impact investing to generate a financial return and measurable social impact at the same time. As the ESG movement grows, it is becoming more apparent that, with a little creativity, there are as many ways for PE sponsors to address investors’ expectations regarding ESG issues as there are issues themselves.
Endnotes


2 PRI data available at: https://www.unpri.org/signatories/signatory-directory.


4 Id., p. 42.

5 See PRI, “What are the Principles for Responsible Investment?”, available at: https://www.unpri.org/pri/what-are-the-principles-for-responsible-investment;

6 Asset owners are pension funds, insurers, banks, sovereign wealth funds, foundations, endowments, family offices, individuals etc., who have legal ownership of assets and can manage and make asset allocation decisions or outsource their management to asset managers. See BlackRock, “Who Owns The Assets?” (May 2014), available at: https://www.blackrock.com/corporate/literature/whitepaper/viewpoint-who-owns-the-assets-may-2014.pdf.


9 Formally known as the Public Company Accounting Reporting and Investor Protection Act of 2002.

10 Formally known as the Dodd-Frank Wall Street Reform and Consumer Protection Act of 2010.


The relevant regulations are (i) the Pension Protection Fund (Pensionable Service) and Occupational Pension Schemes (Investment and Disclosure) (Amendment and Modification) Regulations 2018, and (ii) the Occupational Pension Schemes (Investment and Disclosure) (Amendment) Regulations 2019.


Compliance Week, “Understanding Canada’s new diversity disclosure requirements” (1 October 2019), available at: https://www.complianceweek.com/boards-and-shareholders/understanding-canadas-new-diversity-disclosure-requirements/27805.article.


Financial Post, “Canadian companies can care about more than profit, and could pay a price if they don’t” (3 June 2020), available at: https://business.financialpost.com/business/canadian-companies-can-care-about-more-than-profit-and-could-pay-a-price-if-they-dont.


Id.
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