RESPONSIBLE INVESTMENT IN FUNDS
WITH AGE COMES RESPONSIBILITY

James Burdett and Jon Unger of Baker McKenzie examine how the characteristics of the private equity industry shape the integration of responsible investment provisions in fund documents.

Over the past half century, private equity has flourished and become a significant financial asset class in its own right. According to Preqin, a leading source of data and intelligence for the alternative assets industry, as at 31 December 2016, the global private equity sector had assets under management of $4.59 trillion.

The size of the industry, coupled with its typical active buy-and-hold strategy, means that there is a meaningful opportunity for it to drive change in the world of responsible investment if there is engagement from the industry's key stakeholders (*see box "What is responsible investment?"*). Historically, however, there has been a perception by some in the sector that responsible investment is an administrative burden, a distraction from the efficient execution of the deal and an impediment to extracting the greatest value from the investment.

Although there are still some who subscribe to this point of view, there is a growing recognition of the benefits of responsible investment and the application of responsible investment principles having material positive effects on the performance of private equity funds (*see box "The benefits of responsible investment"*). Despite the shift in sentiment, this has not always translated into firm commitments from fund managers on environmental, social and governance (ESG) matters in fund documents.

Various international non-governmental organisations have been working to progress the engagement of the industry in responsible investment, and at the forefront of this is the United Nations-supported Principles for Responsible Investment (PRI). In July 2017, the PRI refocused the industry's attention on this subject when it issued its guidance on incorporating responsible investment requirements into private equity fund terms (PRI guidance) (*www.unpri.org/press-releases/pri-launches-private-equity-fund-terms-guide*).

This article examines:

- The characteristics of the private equity industry and its participants, and how they shape the integration of responsible investment provisions in fund documents.
- The key fund documents and how they influence the dissemination of responsible investment provisions among investors.
- How responsible investment requirements are typically reflected in fund documents.
- The impact of the PRI and the PRI guidance on the responsible investment debate.

- The likely impetus for change in ESG provisions in fund documents.

CHARACTERISTICS OF THE INDUSTRY

It is essential to understand the dynamics of the private equity industry and its participants to be able to appreciate the motives for both investors and fund managers when deciding how to incorporate or address responsible investment language in private equity fund documents (*see "Differing approaches to responsible investment" below*).

Structure of the fund

A private equity fund is typically structured as a limited partnership, with two types of partners: a general partner, representing the fund manager, and limited partners, being the investors. For both legal and practical reasons it is the general partner and the fund manager who have discretion over the operation of the fund and the management of its investments. An investor typically invests in the fund based on the fund manager's track record. If an investor were to be involved in the control or management of the limited partnership, this may compromise its limited liability status.

Type of investment

Private equity fund investments are often categorised as a long-term, illiquid, blind pool investment. Essentially, an investor will commit capital to a fund:

- For a significant period of time, typically ten to 12 years.
- With a defined investment policy, although the investor will often have limited, or no, visibility on what actual assets will be acquired by the fund on its admission to the fund.
- With virtually no option to redeem and with a limited secondary market to sell its interest.

Investors

The private equity market is now dominated by institutional investors from all corners of the globe. As these investors are often subject to specific legal, tax and regulatory rules, they may look for additional comfort in the fund documents to ensure that they reap the benefits or mitigate the burden of these rules.

It can be challenging for the fund manager and its legal counsel to manage and accommodate the expectations of a significant number of investors, as highlighted by the process of granting side letters (*see "LPA and side letters" below*).

Size of teams

Private equity firms usually operate with smaller, more specialised teams when compared to equivalent corporations operating in the same area. These teams often have less capacity to commit to regulatory and administrative requests from their investors. Accordingly, the fund's general counsel and management will need to be acutely aware of what ongoing compliance obligations are being agreed with investors.

Efficient execution of deals

Private equity investment professionals are frequently involved in competitive bids for investments under testing deadlines. Private equity managers will often be wary of investor requests that might restrict the freedom of the deal teams to execute transactions.

Cumulatively, these factors tend to intensify the negotiation process between investors and managers. Investors see themselves as making a substantial long-term commitment to an illiquid investment, with limited visibility of, or control over, what will be acquired during the life of the fund. Investors will be mindful of these factors and will typically enter into negotiations with a list of requests that seek to protect their position, particularly for cornerstone investors.

A fund manager will need to balance the expectations of investors against its ability to operate the fund smoothly and execute deals efficiently. The fund manager often needs to push back on investor demands and hold out for standardised investor protections to avoid agreeing terms that excessively burden its ability to manage the fund (*see "Fund documents" below*).

> ### What is responsible investment?
>
> There are various definitions of responsible investment. The United Nations-supported Principles for Responsible Investment defines responsible investment as "an approach to investing that aims to incorporate environmental, social and governance (ESG) factors into investment decisions, to better manage risk and generate sustainable, long-term returns".
>
> The British Private Equity & Venture Capital Association's guide on responsible investment for private equity and venture capital firms contains a detailed list of ESG factors in the private equity sphere (*www.bvca.co.uk/Portals/0/library/documents/RI%20Guide%202014.pdf?ver=2016-11-01-094221-910*).

DIFFERING APPROACHES TO RESPONSIBLE INVESTMENT

The term "private equity" is commonly interpreted in two ways: either narrowly to mean only buyout funds, or more widely to mean any closed-end private investment funds, including debt, infrastructure, real estate, and natural resources funds. This article uses the wider definition, which encompasses a myriad of different types of funds, managers and investors. It is therefore important to highlight how these different elements can affect the industry's (or that part of the industry's) view of responsible investment.

Fund managers

Typically, the amount of time and resources that a fund manager will be able to engage in responsible investment will be dictated by the size of its team. While smaller firms are unlikely to have an ESG policy and may have limited capacity to focus on ESG issues, an increasing number of larger private equity firms are expanding their ESG footprint and hiring specialist ESG professionals to support their business to consider ESG risks and opportunities at each step of the investment life cycle.

As highlighted in a survey published by Preqin in November 2016, there are distinct regional approaches to ESG, with European fund managers leading the charge (*see box "Fund managers that consider ESG factors as part of the deal-making process by location"*). This may reflect the fact that European countries and capital markets are more broadly at the forefront of socially responsible investment practice. The survey shows that North America is the least engaged in ESG, which is disappointing from a responsible investment perspective considering that, according to Preqin, North American fund managers hold

The benefits of responsible investment

There are a number of ways in which private equity funds can benefit from applying responsible investment principles. These include:

- Fostering stronger management, promoting stakeholder relationships and creating better performing companies.
- Protecting or significantly boosting profitability and the value or attractiveness of investments from various perspectives.
- Reducing the likelihood of liabilities arising from poor environmental, social and governance practices.
- Avoiding embarrassing situations that can harm a company's reputation and brand value, as well as potentially adversely affecting the reputation of the fund manager and investors.

$2.582 trillion of assets under management, which accounts for a majority of assets under management by the industry globally.

Investor influence

The largest investors in private equity include pension funds, insurance companies and sovereign wealth funds. As with fund managers, an investor's interest in ESG will often be linked with engagement with responsible investment in the host jurisdiction. Dutch pension plans are noticeable for their focus and passion in negotiating ESG language into their fund documents. However, outside this group, the development financial institutions (DFIs) have historically had the biggest impact in the private equity funds that they invested in.

DFIs are financial institutions established by a single government (bilateral) or sometimes multiple partners (multilateral) to invest in private sector companies or provide lending. Typically, they will have a significant focus on the environmental and social impact, and on good governance in their investments. The advantage that DFIs have is that they typically act as cornerstone investors in funds where, without the DFI's commitment, the fund managers may have struggled to raise a fund, as is the case in particular in emerging markets. Accordingly, a DFI will often be able to get the fund to adopt an ESG code which is the same as, or similar to, its own code as a prerequisite to investment. The UK's CDC Group is one of the more prominent DFIs, and has a code of responsible investing (*www.cdcgroup.com/Documents/Code%20of%20Responsible%20Investing%20March%202017.pdf*).

Investment policy

The fund's investment policy will colour the ability of the fund manager to effect change in the underlying assets that it invests in. For example, a fund whose investment policy dictates that it take controlling positions in the underlying investment will be in a better position than a fund that takes a minority position or whose investment policy focuses only on providing debt finance. Equally, if the investment policy is focused on a particular sector, such as infrastructure, then particular aspects (here, environmental factors) will be of more relevance than to a retail-focused buyout fund.

FUND DOCUMENTS

Responsible investment requirements may be included in the limited partnership agreement (LPA) or side letters. The private placement memorandum (PPM) is a disclosure document which may include disclosures on ESG practice and policies.

LPA and side letters

For private equity funds formed as limited partnerships, the key legal document is the LPA. The LPA sets out the rights and obligations of the general partner and limited partners.

Side letters are a means for the fund manager to grant supplemental or preferential terms to a given investor outside of the fund's LPA and other governing documents. Side letters cover a broad range of topics including tax, regulatory, administrative and fund economics in addition to responsible investment provisions.

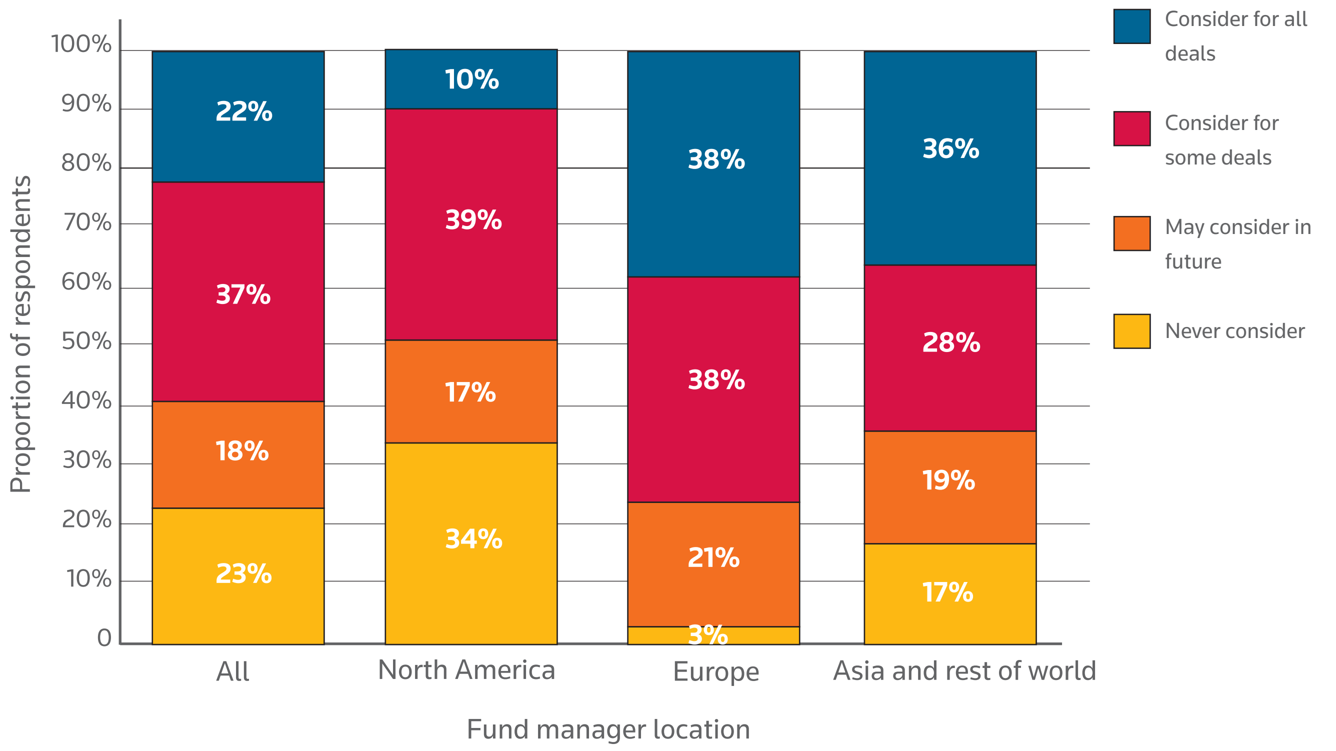
As investors become more sophisticated, there has been a proliferation, not only of the number of side letters being negotiated with investors, but of the kinds of arrangements and provisions included in them. This can result in administrative and cost implications for the fund manager, and it is now generally standard practice for side letter language to be standardised in order to address areas of overlapping concern and for managers to push back quite vigorously on certain side letter requests. This reduces the manager's monitoring and compliance burdens and limits the number of provisions available for most favoured nation election (*see box "MFN provision"*). Despite this, it is not uncommon for a larger buyout fund to have an LPA of around 80 to 100 pages long, and for the compendium of side letter provisions to be up to twice that length.

The side letter was originally intended for investor-specific provisions. However, certain generally applicable provisions, including in relation to ESG, are often included in side letters rather than in the main fund documents. Fund managers will generally try to standardise these across all investors that make similar requests. In these circumstances, it is arguably more appropriate for generally applicable provisions to be set out in the LPA, if they do not result in materially more obligations on the fund manager. The benefit of this approach is that it:

- Reduces the number of side letter provisions granted.
- Reduces the negotiating time and cost.
- Demonstrates that the fund manager is alive to investor concerns.
- Demonstrates goodwill to investors or gains negotiating leverage for the fund manager.
- Increases the level of transparency for the benefit of all investors in the fund, and bolsters the relationship between the investor and the fund manager.

In addition, from the perspective of advancing the ESG debate at the fund and portfolio level, it is arguably preferable for generally applicable ESG provisions to be included in the LPA for greater visibility and as a more overt statement of the manager's ESG credentials.

Fund managers that consider ESG factors as part of the deal-making process by location



Source: Prequin fund manager survey, November 2016

Private placement memorandum

The PPM is the principal marketing document of the fund. It states the strategy and investment parameters of the fund, and a record of past performance. Sometimes, a fund manager may seek to avoid making or giving any formal representations or warranties on ESG matters in the LPA or side letter. When this happens, the investors will often need to rely on the fund manager's past practice instead and, in such a case, PPM disclosures on ESG practice and policies may give the investor a certain degree of comfort.

RESPONSIBLE INVESTMENT PROVISIONS

ESG provisions can, broadly, be split into three overlapping categories:

- Commitments to ESG policy or standards, and compliance with ESG-specific regulations.
- Investment restrictions, exclusions or excuse rights.
- ESG reporting and incident reporting to investors.

Commitments and compliance

Certain investors expect that a general partner and fund manager will comply with a responsible investment standard, whether set out in a policy, principles, code or some other benchmark. Investors usually prefer standards that are sufficiently clear and independent, and are not subject to the discretion and whims of the fund manager. There is a growing popularity in the investor community for fund managers to sign up to an independent standard, such as the PRI's six responsible investment principles (PRI Principles) (*see box "The PRI Principles" and "PRI and PRI guidance" below*).

Where a general partner represents its adherence to a specific standard, it may choose to elaborate on this theme and stipulate that it will use its best (or reasonable) endeavours to act in accordance with that standard in connection with the fund. It might also confirm that it will encourage each of its portfolio companies to do the same. It is quite common for any such assurance to be subject to the investment objectives of the fund, the terms of the LPA, and the fund manager and/or general partner's fiduciary duties to the other investors.

Where the investor is a signatory to an ESG standard, or has adopted its own standard, to which the fund manager or general partner has not adhered, the common approach is for the fund manager or general partner to acknowledge the investor's standard but not to comply with this standard. For more accommodating fund managers and general partners that are seeking to improve their ESG credentials, language may be agreed that they will use best, or reasonable, endeavours to adopt and implement a policy that is reasonably acceptable to the investor in order to systematically address ESG matters with respect to the fund and the portfolio investments.

Restrictions, exclusions or excuse rights

A private equity fund's investment policy will typically be qualified by a list of investment restrictions and exclusions, some of which may be linked to ESG considerations set out in the LPA. The investor, in turn, may have its own investment restrictions that preclude it from investing in certain types of assets, activities or jurisdictions. The general partner may, on occasion, be willing to modify its own investment policy and restrictions by amending the LPA (or adding language to a side letter) to accommodate an investor's preference. However, on the whole, the investor will receive language in its side letter excusing it from making the proscribed investment, but not restricting the investment policy of the fund.

To stop investors cherry picking, general partners will typically expect an investor to give a representation in its excuse right that its participation in the investment would result in a breach of law, regulation, licence or similar. A general partner will sometimes require a legal opinion from the investor's legal counsel confirming this if the excuse right is ever pursued by the investor.

Reporting

Investors may look to supplement the ESG reporting obligations in the LPA by requesting that reporting is folded into the annual report so that the fund's progress on ESG is discussed on an annual basis. Some investors' requests are more prescriptive and set out what the reports will contain, including: a demonstration of ESG integration in the due diligence process and adherence to the investor's investment restrictions or exclusions lists; a demonstration of improvements in the general partner's processes for managing ESG issues within the fund and portfolio companies; and an analysis of the progress made by portfolio companies against prior goals or key performance indicators. Certain investors will seek disclosures outside of annual reports, with the expectation that there are opportunities to engage through ad-hoc meetings or calls, or periodic reporting to the limited partner advisory committee. The Institutional Limited Partners Association's Private Equity Principles 2.0 provide that a general partner's report should include portfolio company and fund information on material risks, and how they are managed, including ESG governance risks at both fund and portfolio company level (*https://ilpa.org/wp-content/uploads/2015/07/ILPA-Private-Equity-Principles-version-2.pdf*).

Incident reporting is of prime importance for investors. ESG incidents can have an immediate negative effect on the reputation and valuation of the portfolio company, and can have a knock-on effect for the reputation of the investor. An investor may seek to negotiate provisions confirming that it will be informed promptly of any such material incidents and be provided with information on corrective action that has been taken to minimise the impact for the fund, and for the investor.

It is market standard for ESG reporting provisions to be set out in a side letter. Ideally, ESG reporting provisions that are generally applicable should be set out in the LPA.

The PRI Principles

Signatories to the United Nations-supported Principles for Responsible Investment commit to the following six principles:

- Incorporating environmental, social and governance (ESG) issues into their investment analysis and decision-making processes.
- Being active owners and incorporating ESG issues into their ownership policies and practices.
- Seeking appropriate disclosure on ESG issues by the entities in which they invest.
- Promoting acceptance and implementation of the principles within the investment industry.
- Working together to enhance their effectiveness in implementing the principles.
- Reporting on their activities and progressing towards implementing the principles (*www.unpri.org/about/the-six-principles*).

PRI AND PRI GUIDANCE

The PRI is an independent non-profit organisation that is supported by, but not part of, the United Nations. The PRI Principles are designed to provide a framework of best practice for asset managers and asset owners from a global perspective. The PRI was established in 2005 and it is already the leading global proponent of responsible investment. The PRI covers all asset classes, not just private equity. As of August 2017, the PRI had more than 1,750 signatories, from over 50 countries, representing approximately $70 trillion of assets under management. The overall goal of the PRI is to understand the investment implications of ESG factors and to support its investor signatories to incorporate due consideration of these factors into their investment decision-making and ownership practices.

Signatories' commitments

Besides their commitment to adopt and implement the PRI Principles, signatories to the PRI Principles have two annual obligations: to report on their responsible investment activities and to pay a fee.

The reporting function and the collation of corresponding data by the PRI serve a number of purposes, including:

- Facilitating learning and development in the industry, which promotes dialogue and debate and keeps the issue of responsible investment on the agenda.
- Identifying areas for the signatories to make further improvements in their own practices.
- Facilitating a dialogue between managers and investors on responsible investment activities and capabilities. This gives managers the opportunity either to laud their strengths to existing and prospective investors, or to give existing and prospective investors the opportunity to engage with the manager on their expectations for improvement.

Role of the PRI guidance

The PRI guidance is the second instalment in a three-part series of tools designed to advance dialogue in relation to responsible investment in the private equity space. The first instalment was the PRI's Limited Partners' Responsible Investment Due Diligence Questionnaire and accompanying guidance published in November 2015, which is intended to encourage standardised due diligence on ESG considerations in private equity (*www.unpri.org/news/pri-launches-private-equity-due-diligence-question*). The third instalment is due to be published in

2018, with guidance on consistent approaches to ESG reporting during the lifetime of the fund.

The PRI guidance on fund terms serves as a forum to:

- Clarify the purpose of responsible investment provisions in fund documents.
- Identify current and emerging best practice as well as constraints.
- Highlight practical options for the incorporation of responsible investment provisions into fund terms.
- Harmonise the approach taken by market participants.

The PRI guidance appreciates that there is not necessarily a one-size-fits-all solution for such a broad industry and does not seek to prescribe a particular approach in which commitments should be formalised in fund documents (*see "Differing approaches to responsible investment" above*). The ultimate goal of the PRI guidance would appear to be to keep ESG issues in the spotlight and to progress the debate with a view to working towards industry consistency and harmonisation. The PRI guidance looks to the future and anticipates that relatively soon there will be further demand from the industry for guidance on this topic from the PRI.

MFN provision

One of the key provisions that investors expect to see reflected in the fund documents, either in the limited partnership agreement or in a side letter, is the most favoured nation (MFN) provision. At its core, the MFN provision is an investor protection provision which entitles an investor to be informed of and benefit from rights given by side letter to other investors. However, as the length and number of side letters has increased, fund managers have become ever more discerning as to how the MFN provision is structured. It is standard for MFN provisions to:

- Be "tiered", whereby an investor will only benefit from (and in some cases only have sight of) those side letters entered into by other investors that have committed the same or less to the fund as that investor.
- Have a number of carve-outs. Some typical carve-outs from the MFN provision include:
  - the right to appoint a limited partner advisory committee member;
  - rights to co-invest alongside the fund (sometimes on a preferential basis);
  - rights to transfer partnership interests;
  - management fee rebates; and
  - provisions granted to address legal, tax, regulatory, or policy issues. Alternatively, these provisions may be available through the MFN election process to investors that are affected by the same legal, tax, regulatory or policy issues.

IMPETUS FOR CHANGE

Although there has been some movement towards greater engagement by fund managers in responsible investment provisions in fund documents, there is still some way to go. If there is to be a material change, there needs to be a considerable shift in the current balance of power from general partners to limited partners. There are a number of factors that are likely to contribute to this.

Investor pressure

When a significant group of investors, particularly cornerstone investors, are engaged in advancing ESG principles in their dealings with general partners at the fundraising stage rather than treating them as a "nice to have", a further shift is likely to be reflected in fund documents in the investors' favour. Although there are some investors who are already pushing through the responsible investment agenda, in particular DFIs and some European pension funds, there are still many in the investor community who do not yet focus their energies on the issue or do not have the financial clout to effect that change.

Measuring value

It is a challenge to place a monetary value on the intangible benefits of ESG initiatives. Once there are better techniques in the marketplace to measure this value, this should facilitate communication with potential investors about responsible investment in terms that they can understand, and establish a robust business case for further engagement with portfolio companies on ESG issues. It should also demonstrate to the sceptics in the private equity firms the value of investing time and resources in an ESG approach.

Documenting ESG provisions

There is currently a relatively consistent market practice as to how generally applicable ESG provisions are dealt with in fund documents. There are compelling arguments for a greater proportion of these provisions to be located in the LPA, rather than in side letters (*see "LPA and side letters" above*). Whether this approach reflects a lack of investor pressure or the fund managers' initiative is a matter for debate. As and when the market-leading fund managers start to move these provisions away from side letters, there may be a growing consensus for change in the market.

Fundraising

The past year has seen one of the highest levels of activity in private equity fundraising in the past decade. In this environment, fund managers with a strong track record will often be able to dictate terms and limit the additional concessions that they make. In contrast, during the global financial crisis that began in 2008, the fundraising market was much more challenging and fund managers regularly conceded relatively significant points; especially if they were to gain traction with big ticket investors. As and when it becomes significantly harder for fund managers (in particular top quartile managers) to raise capital, this may be reflected in the fund document provisions.

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Reputation

Fund managers and investors operate under the scrutiny of an ever-growing number of vigilant stakeholders, such as non-governmental organisations (NGOs), governments, regulators and even the general public and the press. Reputation is fundamental to all market participants and can be quickly damaged by poor decisions.

In 2013, it came to light that the Church of England's pension fund, the Church Commissioners, through its investment in an Accel Partners fund, held an indirect stake in the controversial payday lender Wonga. This caused great embarrassment to the Church as, previously, the Archbishop of Canterbury had decried payday lenders as "morally wrong" and threatened to "compete them out of existence" by establishing a rival network of credit unions. After this came to light, the Church Commissioners chose to tighten their investment restrictions for both direct and indirect investments. Other groups of investors are similarly sensitive to public perception, such as sovereign wealth funds and public sector pension funds, and similar incidents may cause them to revisit their ESG provisions.

Regulatory change

ESG considerations have driven a number of new regulations in a growing list of countries. For example, in 2016, France introduced an amendment to its Energy Transition Law which made it the first country to impose mandatory climate reporting for investors. In December 2016, the revised Directive on the activities and supervision of institutions for occupational retirement provision (*2016/2341/EU*) (IORP II) was adopted in the EU, requiring occupational pension providers to evaluate ESG risks and disclose information to current and prospective scheme members (*www.practicallaw.com/9-638-0377*). The PRI's global guide to responsible investment regulation provides an in-depth overview of the impact of responsible investment regulation (*www.unpri.org/page/responsible-investment-regulation*).

Trade associations and investor networks

Trade associations such as Invest Europe, the Emerging Markets Private Equity Association (EMPEA), the British Private Equity & Venture Capital Association (BVCA), L'Association Française des Investisseurs pour la Croissance and the American Investment Council (AIC), and investor networks such as the PRI, the Institutional Investors Group on Climate Change and Ceres, are particularly active in the area and play an important role in keeping the topic of responsible investment firmly on the table. For example:

- The Institutional Limited Partners Association (ILPA) Due Diligence Questionnaire has incorporated the PRI Limited Partners' Responsible Investment Due Diligence Questionnaire (*https://ilpa.org/best-practices/due-diligence-questionnaire/*).

- The AIC Guidelines for Responsible Investing are adopted by its members and may be referenced in their policies and fund terms (*www.investmentcouncil.org/industry-resources/guidelines-responsible-investing/*).

- The Invest Europe Professional Standards Handbook provides guidance on how ESG factors might be considered and reflected throughout the lifecycle of the fund (*www.investeurope.eu/about-us/professional-standards/professional-standards-handbook/*).

Initiatives such as these highlight the benefits of responsible investment in private equity and create dialogue between the key stakeholders in the industry. This brings about greater consensus for how the industry should progress on these key issues.

Demographic changes

So-called millennials and generation X are increasingly taking over from baby boomers in positions of influence, and are therefore changing business, financial and political landscapes. There is not just a change in guard in fund managers and investors, but in all sectors of society. This should be expected to lead to a greater expectation for progress in responsible investment.

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