ESG In Private Equity: What Every GP Needs to Know About Public Pension Fund Requirements

October 24, 2017

Public pension funds have long been outspoken advocates of environmental, social & governance (ESG) principles in investing. As quasi-public institutions uniquely sensitive to public opinion and the political process, public pension funds have begun to incorporate ESG considerations into all asset classes in their portfolio, including their private equity investments. With public pension fund limited partner (LP) investments constituting 44% of total worldwide private funding by the top 100 LPs in private equity,[1] the largest category of private equity LP type by far among this group, it is important that private equity firms understand the ESG expectations of public pension funds and assess on an ongoing basis whether their ESG policies and practices, and those of their portfolio companies, are responsive.

This memorandum describes how public pension funds integrate their ESG policies in LP investments with private equity funds. We reviewed 10 North American public pension funds with some of the largest stakes in private equity[2]: (1) Canada Public Pension Investment Board (CPPIB), (2) California Public Employees Retirement System (CalPERS), (3) Ontario Teachers' Pension Plan (OTPP), (4) Caisse de dépôt et placement du Québec (CDPQ), (5) Washington State Investment Board, (6) California State Teachers' Retirement System (CalSTRS), (7) Teacher Retirement System of Texas (TRS), (8) New York State Common Retirement Fund (NYS Fund), (9) Oregon Public Employees Retirement Fund (Oregon PERS), and (10) Florida Retirement System Pension Plan (FRS).[3]

Key Findings

1. **Support for ESG Policies in the Public Pension Fund Community Is Broad**. A 2015 CFA Institute survey of institutional investors – including many public pension funds – found that 73% of respondents incorporate ESG factors into their investment decisions. Currently, eight of the 10 pension funds discussed in this memorandum incorporate ESG principles into at least some aspects of their investing decisions. Four of the funds were founding signatories of the United Nations Principles of Responsible Investing (PRI), one of the world's leading proponents of responsible investment.[4] Two of the other funds (for a total of six) are now PRI signatories.[5] Additionally, nine of the funds have endorsed the Institutional Limited Partners Association's (ILPA) Private Equity

[1] https://www.preqin.com/docs/reports/Preqin-Special-Report-The-Private-Equity-Top-100-February-2017.pdf.

[2] *Id.*

[3] The purpose of this memorandum is to provide a snapshot of certain North American public pension fund LPs. It is not meant to be a comprehensive survey of all public pension fund LPs worldwide, particularly of Scandinavian, Dutch or other pension funds, whose ESG policies in private equity are well-developed and will be the subject of a separate memorandum.

[4] https://www.unpri.org/. CPPIB, CalPERS, CDPQ, and NYS Fund were founding signatories of PRI. An independent non-profit, PRI works to understand the investment implications of ESG factors and support its signatories in incorporating these factors into their investment and ownership decisions.

[5] CalSTRS and OTPP became signatories in 2008 and 2011, respectively.

Principles, a set of best practices that addresses, among a variety of topics, private equity governance.[6]

2. **Some ESG Policies in Private Equity Are a Work in Progress**. Public pension funds have traditionally focused and continue to focus their ESG efforts on their public company investments. However, integrating ESG into their private equity investment decisions is less widespread. Based on our search of publicly available information, it appears that only four of the 10 public pension funds discussed herein have developed private equity specific policies to integrate ESG considerations into their LP investments. Further, the extent and sophistication of this integration process varies. CalPERS, for example, integrates ESG into all stages of its private equity investments from pre-commitment due diligence and the negotiation of side letters and LPA provisions with private equity general partners (GPs) to monitoring ESG matters during the life of the investment. Other pension funds appear to focus their ESG efforts during the pre-commitment diligence or during side letter negotiations. If such policies become more widely adopted and developed, GPs should expect their LPs to impose increasingly more stringent ESG requirements.

Public Pension Fund ESG Policies Summary

1. **Canada Public Pension Investment Board (CPPIB)**

Overview: CPPIB is an investment management organization that manages the assets of the Canada Pension Plan. CPPIB has $317 billion in assets under management, of which approximately $58 billion (or approximately 19%) is invested in private equity.[7] CPPIB believes "ESG factors have the potential to be significant drivers – or barriers – to profitability and shareholder value."[8] As a result, CPPIB integrates ESG evaluation into all levels of its investment decisions.

CPPIB integrates ESG factors across all asset classes. This integration is monitored and supported by CPPIB's in-house Sustainable Investing group. The Sustainable Investing group also manages CPPIB's ongoing research and analysis on "companies, sectors, issues, standards and best practices" in addition to managing proxy voting activities.[9]

Diligence: At the initial investment stage, CPPIB evaluates private equity firms by using an ESG questionnaire that elicits information regarding (1) the alignment of ESG policies between the firm and CPPIB, (2) the firm's practices with respect to ESG due diligence in connection with potential new portfolio investments, (3) the resources the firm commits to ESG matters, and (4) the firm's ESG monitoring and reporting procedures during the life of a portfolio investment.[10] CPPIB uses the findings from this diligence process and any subsequent conversations with the GP to inform its final investment decision.

Contracting: Our review has not identified any public information regarding what ESG language CPPIB requires in its agreements (or side letters) with private equity firms.

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[6] **https://ilpa.org/wp-content/uploads/2017/04/April-5-2017-Updated-Endorsement-List.pdf.** CDPQ is the only fund we reviewed that does not publicly endorse the ILPA Private Equity Principles.

[7] **http://www.cppib.com/documents/1591/2017_Annual_Report.pdf.**

[8] **http://www.cppib.com/en/how-we-invest/sustainable-investing.**

[9] **http://www.cppib.com/documents/4/Sustainable_Investing_2016.pdf.**

[10] *Id.*

Engagement: After CPPIB enters into an agreement with a private equity fund, it remains "actively involved in the ongoing monitoring of the GP's ESG practices."[11] This ongoing monitoring is "then incorporated into quarterly and annual fund monitoring processes as appropriate."

Key ESG Memberships: CPPIB was a founding signatory to the PRI and member of CDP (formerly the Carbon Disclosure Project).

2. California Public Employees Retirement System (CalPERS)

Overview: CalPERS is a pension fund that manages benefits for more than 1.6 million California employees with over $340 billion in assets under management, $25.9 billion (or approximately 9%) of which is in private equity.[12] CalPERS' ESG policies are embodied in a series of principles referred to as "Investment Beliefs,"[13] which among other things, assert the importance of ESG factors to long-term value creation and that investment decisions may "reflect wider stakeholder views" as long as they are consistent with the interests of its beneficiaries. CalPERS refers to these principles in its decision-making process.

In recent years, CalPERS has begun to integrate ESG policies across all asset classes in its investment portfolio, including private equity. In 2013, PRI, working with a group of more than 40 LPs – including CalPERS and OTPP – along with private equity associations and 10 GPs, developed a number of guidelines regarding the information GPs should disclose to investors at the diligence stage and throughout the life of the fund. These disclosure guidelines are known as the Environmental Social and Corporate Governance Disclosure Framework for Private Equity (PRI ESG PE Framework).[14] CalPERS subsequently adopted elements of this framework into its own Private Equity Sustainable Investment Practice Guidelines,[15] which incorporates ESG into all stages of CalPERS' private equity investments. CalPERS management periodically assesses how these guidelines are being implemented in practice.

Diligence: CalPERS integrates ESG into its diligence of private equity investments. This is a two-step process. First, a screening tool is employed which results in an overall score. This score is designed to enable CalPERS to determine whether a more fulsome diligence process is warranted. One factor in this score analysis is a private equity fund's maintenance of an ESG policy.

The next stage of the diligence process involves a deeper dive into the fund's ESG policies, including an evaluation of the fund's integration of ESG into its diligence of investment targets. Furthermore, on a regular basis throughout the life of an investment, CalPERS examines how the fund engages with its portfolio companies on ESG issues, and analyzes any ESG-related litigation. The results of this review are summarized in the ESG section of CalPERS' internal diligence report, and any material ESG concerns are discussed with CalPERS' Private Equity Investment Review Committee before an investment is approved.[16]

Contracting: Once CalPERS approves a private equity investment, it attempts to execute side letters with the private equity fund requiring fund managers to incorporate ESG factors into their investment process and report regularly on their progress. According to a CalPERS review in March 2017, "a vast

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[11] *Id.*

[12] https://www.calpers.ca.gov/page/investments/asset-classes/asset-allocation-performance/investment-fund-values.

[13] https://www.calpers.ca.gov/docs/forms-publications/calpers-beliefs.pdf.

[14] The ESG PE Framework is available at https://www.unpri.org/download_report/6230.

[15] https://www.calpers.ca.gov/docs/board-agendas/201703/invest/item08a-04.pdf.

[16] *Supra* note 15.

majority" of private equity commitments made in the 16 months prior to the review included an ESG section in a side letter or LP agreement.

Engagement: CalPERS monitors ESG matters in its private equity investments in a number of ways. With respect to the top 10 managers in CalPERS' private equity portfolio, CalPERS' staff will inquire into ESG issues at each fund's annual Limited Partner Advisory Committee (LPAC) meeting, including the ongoing process for identifying ESG risks and opportunities, material ESG issues that may impact the value of the portfolio and ESG-related litigation. For other private equity investments, CalPERS staff will document any ESG-related issues identified at periodic meetings. Finally, CalPERS will review, on an annual basis, any ESG reports issued by the private equity firm.

Key ESG Memberships: CalPERS was a founding signatory to the PRI and actively engages with PRI staff by providing feedback regarding progress of the PRI principles in the market, including its participation in the current PRI working group on Private Equity Monitoring and Reporting Guidance.[17] Additionally, CalPERS was a participant in the development of the PRI ESG PE Framework, a founding member of SASB's Investor Advisory Group,[18] and a member of the Coalition for Environmentally Responsible Economics (Ceres).[19]

3. Ontario Teachers' Pension Plan (OTPP)

Overview: OTPP is the largest single-profession pension plan in Canada, managing $176 billion in assets for 318,000 active and retired teachers.[20] Over 15% of OTPP's portfolio is invested in private equity. OTPP is committed to integrating ESG in all stages of its investments and across all asset classes.[21] To meet this commitment, it has "established a set of five responsible investing principles" that inform its investment decisions.[22] This approach, which is guided by its "responsible investing governance framework," begins at the opportunity stage, when the portfolio managers identify possible target investments, and extends to the long-term management of the investment through regular monitoring of ESG risks.

Diligence: OTPP's ESG framework addresses due diligence for all forms of its investments. For investments in private equity, it has developed an ESG "due diligence questionnaire" that is required for all first-time commitments. Additionally, OTPP has "initiated a review of all existing fund managers" using its responsible investing governance framework.[23]

Contracting: OTPP requires its external managers to agree, "where applicable, to vote their share in a manner consistent with [OTPP's] Corporate Governance Principles," however, it is unclear whether OTPP imposes this requirement on managers of public investments only or to private equity GPs as well.[24]

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[17] https://www.unpri.org/news/pri-and-erm-launch-project-to-develop-private-equity-reporting-guidance. The group expects to release this guidance document in 2018.

[18] SASB's focus is on the creation and maintenance of sustainability accounting standards for public corporations.

[19] Ceres is a sustainability nonprofit organization, which regularly works with various leading investors and companies on ESG matters.

[20] https://www.otpp.com/documents/10179/771876/-/aaaf4912-f652-4ba4-8c6c-ce28b9894fd9/Annual%20Report.pdf.

[21] https://www.otpp.com/investments/responsible-investing/our-principled-approach/principles-and-practice.

[22] Id.

[23] https://www.otpp.com/documents/10179/772241/-/0475233f-83dd-4a73-a406-c34b56f09fec/OTPP_RI_Report2016_ENG.pdf.

[24] *Supra* note 21.

Engagement: As a pillar of its responsible investing principles, OTPP is committed to continually assess "current and emerging ESG risk."[25] This continual assessment includes open dialogue with private equity managers and the occasional use of "expert consultants and databases to advise [OTPP] of potential ESG factors."[26] Additionally, as noted above, OTPP was a participant in the development of the PRI ESG PE Framework, which is aimed at improving the flow of ESG information between LPs and GPs.

Key ESG Memberships: OTPP is a member of PRI and is a participant in PRI's current working group on Private Equity Monitoring and Reporting Guidance. OTPP participated in the development of the ESG PE Framework. Additionally, OTPP is a member of CDP and a founding member of SASB's Investor Advisory Group.[27]

4. Caisse de dépôt et placement du Québec (CDPQ)

Overview: CDPQ is an institutional investor that manages over $286 billion in assets, of which over $30 billion (or approximately 11%) is invested in private equity.[28] CDPQ is among the 10 largest private equity investors in the world, based on annual private equity commitments.[29] A majority of CDPQ's depositor base is made up of public and partially public pension plans, including the Québec Pension Plan.

CDPQ believes that ESG considerations are an integral part of an investment's long-term risk factor. Therefore, CDPQ integrates ESG criteria into its investment analysis and decision-making across all asset classes. To facilitate this goal, CDPQ encourages open disclosure of ESG-related information. This integration is explicit in the overall analysis of new, actively managed investments. However, CDPQ has not publicly stated its approach to dealing with ESG in relation to investments in private equity funds.

Diligence: Our review has not identified any information regarding what ESG considerations CDPQ includes in its due diligence process.

Contracting: Our review has not identified any information regarding what ESG language CDPQ requires in its agreements (or side letters) with private equity firms.

Engagement: Our review has not identified any information regarding how CDPQ manages its private equity investments with respect to ESG.

Key ESG Memberships: CDPQ was a founding signatory to the PRI and is a member of CDP and Ceres.

5. Washington State Investment Board (WSIB)

Overview: WSIB manages $120 billion in assets, of which $18.7 billion (or approximately 16%) is invested in private equity.[30] The Board represents 17 retirement plans for Washington State public employees. As a long-term investor, one of WSIB's stated investment beliefs is in "Sustainable and Responsible Investing."[31] This belief requires the identification of ESG-related risks throughout WSIB's investment structure. Additionally, WSIB expects "full disclosure of [ESG] risk anticipated by the

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[25] *Id.*

[26] *Id.*

[27] *Supra* note 18.

[28] https://www.cdpq.com/en/investments/overall-portfolio.

[29] https://www.cdpq.com/en/investments/private-equity.

[30] http://www.sib.wa.gov/financial/pdfs/quarterly/qr063017.pdf.

[31] http://www.sib.wa.gov/financial/pdfs/db_investment_beliefs_sustainable.pdf.

companies in which [they] invest and the investment managers with whom [they] partner, along with the full disclosure of what [the partners] are doing to manage these risks."[32]

Diligence: Our review has not identified any information regarding what ESG considerations WSIB includes in its due diligence process.

Contracting: Our review has not identified any information regarding what ESG language WSIB requires in its agreements (or side letters) with private equity firms.

Engagement: Our review has not identified any information regarding how WSIB manages its private equity investments with respect to ESG.

Key ESG Memberships: WSIB is a member of Ceres and its Investor Network on Climate Risk (INCR).

6. California State Teachers' Retirement System (CalSTRS)

Overview: CalSTRS is the largest educator-only pension fund in the world, managing approximately $215 billion in total assets, making it the second largest pension fund in the United States.[33] As of June 2016, approximately 8.7% of CalSTRS' portfolio was invested in private equity. CalSTRS has a long-standing commitment to ESG, dating back to 1978, when it adopted the "Statement of Investment Responsibility."[34] Since then, CalSTRS has developed an "Environmental Program" that uses "a four-pronged plan that includes structuring an environmentally focused equity program, targeting private investment in clean technologies, auditing the real estate portfolio efficiency to increase long-term value, and demanding environmental accountability and disclosure from portfolio investments."[35] CalSTRS manages ESG risks, both internal and external, through its "21 Risk Factor" analysis.[36] However, as noted below, our review has identified limited information regarding the extent to which CalSTRS integrates these factors into its private equity investments.

CalSTRS encourages open disclosure of ESG information with respect to its public equity investments. In 2016, with respect to public companies, it formally commented on the SEC's "concept release surrounding Business and Financial Disclosure Required by Regulation S-K. CalSTRS staff emphasized that the SEC should focus on requiring industry-specific standardized metrics to disclose material ESG information, requiring robust discussion of an issuer's industry-specific, long-term ESG risks and opportunities."[37] Its disclosure policies with respect to its private equity investments are unclear.

In January 2017, CalSTRS discussed plans to modify its 21 Risk Factor analysis from a rule-based to a more principles-based approach. This change would better align CalSTRS' ESG policy to the principle-based approach endorsed by PRI.[38] At the July 2017 meeting of CalSTRS' investment committee, it introduced the draft principle-based ESG policy.[39] Once approved, this revised policy would be

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[32] *Id.*

[33] https://www.calstrs.com/investments-overview.

[34] https://www.calstrs.com/sites/main/files/file-attachments/esg_policy_and_21_risk_factors.pdf.

[35] http://www.calstrs.com/sites/main/files/file-attachments/sustainabilityatcalstrs.pdf.

[36] *Supra* note 34.

[37] https://www.calstrs.com/news-release/calstrs-corporate-governance-program-elevated-its-voice-policy-2016.

[38] http://resources.calstrs.com/publicdocs/Page/CommonPage.aspx?PageName=DocumentDownload&Id=d4800784-62e6-423e-a244-81666a117e9d.

[39] https://resources.calstrs.com/publicdocs/Page/CommonPage.aspx?PageName=DocumentDownload&Id=b47cafb0-4309-4158-832c-b68b704b9489.

implemented across asset classes. According to CalSTRS, "[t]his process includes working with external managers so they understand this new updated policy, how it will be incorporated into their agreements and how they are to carry out this policy on CalSTRS behalf".[40]

Diligence: CalSTRS is continuously monitoring its diligence process to assess how ESG issues can be better integrated into its diligence efforts.

Contracting: CalSTRS Private Equity Investment Policy provides that external fund managers are expected to implement its 21 Risk Factor analysis. However, our review has not identified any specific contractual requirements with respect to the implementation of the 21 Risk Factors.

Engagement: CalSTRS submits an annual questionnaire to evaluate the ESG-related activates of its partners. It uses its 21 Risk Factor analysis to continuously monitor its investments and "CalSTRS' external fund managers are regularly queried on how they are factoring these risk factors into investment decisions made on behalf of CalSTRS".[41]

Key ESG Memberships: CalSTRS is a signatory to the PRI, member of CDP and Ceres, and a founding member of SASB's Investor Advisory Group.

7. Teacher Retirement System of Texas (TRS)

Overview: TRS manages $134 billion in assets for over 1.5 million participants. Approximately $16 billion (or approximately 12%) of TRS' assets are invested in private equity.[42] In 2017, TRS' board considered implementing an ESG policy and determined that no policy revisions were necessary.[43] There are currently no other public documents that discuss any current or future ESG policy of TRS.

Diligence: Our review has not identified any information regarding what ESG considerations TRS includes in its due diligence process, if any.

Contracting: Our review has not identified any information regarding what ESG language TRS requires in its agreements (or side letters) with private equity firms, if any.

Engagement: Our review has not identified any information regarding how TRS manages its private equity investments with respect to ESG, if any.

Key ESG Memberships: None publicly disclosed.

8. New York State Common Retirement Fund (NYS Fund)

Overview: The NYS Fund manages $192 billion in assets on behalf of almost 1.1 million New York State employees, retirees and beneficiaries. Approximately $14 billion (or approximately 7%) of the NYS Fund's assets are invested in private equity.[44] While the NYS Fund has been an advocate for ESG concerns for over a decade, in 2015 it began a review of its ESG policies. This culminated with the publication of the NYS Fund's 2017 Environmental, Social and Governance Report.[45] The report outlines NYS Fund's overall ESG strategy. This strategy focuses on the integration of ESG criteria across all asset classes.

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[40] *Id.*

[41] https://www.calstrs.com/sites/main/files/file-attachments/green_report_2016.pdf.

[42] https://www.trs.texas.gov/TRS%20Documents/cafr_2016.pdf.

[43] https://www.trs.texas.gov/TRS%20Documents/board_meeting_book_feb2017.pdf.

[44] http://www.osc.state.ny.us/pension/snapshot.htm.

[45] http://osc.state.ny.us/reports/esg-report-mar2017.pdf#search=%20ESG.

One element of the strategy uses the newly created "ESG Risk Assessment" as a tool in the selection of external managers, including private equity firms.[46]

Diligence: The NYS Fund uses its recently developed ESG Risk Assessment to evaluate external managers' ESG policies and performance as part of its due diligence process. The ESG Risk Assessment covers four areas: (1) transparency (what ESG information does the manager disclose?), (2) information (what information sources does the manager use with respect to its own ESG analysis?), (3) process (how is ESG incorporated into the manager's investment decisions?), and (4) engagement (how does the manager engage with portfolio companies?).[47] This assessment culminates in a score that is factored into the overall investment decision-making process.

Contracting: Our review has not identified any information regarding what ESG language the NYS Fund requires in its agreements (or side letters) with private equity firms.

Engagement: Although our review has not identified information that specifically describes the process by which NYS Fund engages with external managers on ESG matters on an ongoing basis, the description of the ESG Risk Assessment suggests that it is not limited to pre-investment diligence, but is designed to apply to managers already engaged by the NYS Fund. Note that NYS Fund's ESG Strategy was recently developed and is likely to evolve over time.

Key ESG Memberships: The NYS Fund is a founding signatory to the PRI and a member of CDP and Ceres.

9. Oregon Public Employees Retirement Fund (Oregon PERS)

Overview: Oregon PERS manages over $73 billion in assets, of which $14.3 billion (or approximately 20%) is invested in private equity.[48] The Oregon Investment Council (OIC), which manages the Oregon Public Employees Retirement Fund, believes that ESG-related issues can pose an investment risk and has endeavored to improve its integration of ESG and general corporate governance activities.[49] OIC encourages responsible practices through a set of principles, focused on governance and transparency, that it provides to private equity funds.[50]

Diligence: Our review has not identified any information regarding what ESG considerations Oregon PERS includes in its due diligence process.

Contracting: Our review has not identified any information regarding what ESG practices Oregon PERS requires in its agreements (or side letters) with private equity firms.

Engagement: Our review has not identified any information regarding how Oregon PERS manages its private equity investments with respect to ESG.

Key Memberships: Oregon PERS was a founding member of SASB's Investor Advisory Group and a member of CDP and Ceres (all via the Oregon State Treasury).

10. Florida Retirement System Pension Plan (FRS)

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[46] *Id.*

[47] *Id.*

[48] http://www.oregon.gov/treasury/Divisions/Investment/Documents/OPERS/Quarterly%20Returns/OIC%20Board%20Presentation%202q17.pdf.

[49] http://www.oregon.gov/treasury/Divisions/Investment/Documents/Statement%20of%20Investment%20and%20Management%20Beliefs.pdf.

[50] http://www.oregon.gov/treasury/Divisions/Investment/Pages/Corporate-Responsibility.aspx.

Overview: FRS manages $157 billion in assets for nearly one million current and retired Florida public employees.[51] Over $9 billion (or approximately 6%) of FRS' managed assets are invested in private equity. Although the Florida State Board of Administration (SBA), which manages FRS, is a member of CDP, there are currently no public documents that discuss any current or future ESG policy of FRS. Nonetheless, in managing its public assets, SBA has since 2012, utilized Hermes Equities Ownership Services to "support ongoing engagement activities globally for selected issuers with high priority concerns such as poor performance, governance or other ESG rating dimensions."[50]

Diligence: Our review has not identified any information regarding what ESG considerations FRS includes in its due diligence process, if any.

Contracting: Our review has not identified any information regarding what ESG language FRS includes in its agreements with private equity firms, if any.

Engagement: Our review has not identified any information regarding how FRS manages its private equity investments with respect to ESG, if any.

Key ESG Memberships: FRS is a member of CDP and Ceres (via the Florida State Board of Administration).

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[52] https://www.sbafla.com/fsb/Portals/FSB/Content/CorporateGovernance/Reports/2016_CorporateGovernanceAnnualSummarySPREAD.pdf?ver=2016-12-13-171020-610.

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[51] https://www.sbafla.com/fsb/Portals/FSB/Content/Performance/Annual/2015-16%20AIR.pdf?ver=2017-01-03-121048-220.