

October 12, 2021

RESPONSIBLE INVESTING

ILPA ESG Resources: Assessment Framework Utility Depends on Stage of LPs' and GPs' ESG Programs (Part One of Two)

By Helen Kim, *Private Equity Law Report*

The push for environmental, social and governance (ESG) initiatives in the PE space is commonly described as coming from investors. To facilitate those efforts, the Institutional Limited Partners Association (ILPA) has released various resources to provide guidance to investors starting or enhancing their own ESG programs, including a suggested framework for assessing a GP's ESG-integration progress.

To gauge responses and reactions to ILPA's ESG resources, the Private Equity Law Report spoke with ILPA; its working group members (Working Group); and lawyers representing a wide range of GPs and LPs, including institutional investors, large asset managers with advanced ESG programs and emerging managers with no stated ESG policies. Overall, experts on both sides viewed the resources as good starting points for LPs but desired more guidance, especially on benchmarking.

This first article in a two-part series describes ILPA's [ESG Assessment Framework](#) (Framework) that was released in July 2021, including ILPA's objectives, as well as the LPs and GPs that can benefit from using it. The [second article](#) will discuss the ESG Roadmap,

released publicly in May 2021, as well as other ILPA ESG resources and the potential impact of those resources on the PE industry.

See our three-part series on ILPA's 2019 model limited partnership agreement (LPA): "[Seeks to Empower LPACs and Increase GP Accountability for Fiduciary Duties](#)" (Dec. 10, 2019); "[Attempts to Redistribute Economic Risk From LPs to GPs](#)" (Dec. 17, 2019); and "[Faces Sizable GP Skepticism En Route to Becoming a Fixture in PE Fund LPA Negotiations](#)" (Jan. 7, 2020).

Background

Framework Fundamentals

The Framework sets out four categories of ESG integration activities and processes:

1. policies and commitments to standards;
2. governance;
3. communications and reporting; and
4. investment process.

Each category contains multiple components. For example, the communications and reporting category is composed of the

approach to communication; incident reporting; and key performance indicators (KPIs) and reporting.

Stages of ESG integration are described across four buckets of relative progress: not present, developing, intermediate and advanced. Each bucket, for each component of each category, contains a description of what LPs could look for in their GPs' ESG programs.

For example, in the KPIs and reporting component, a GP in the not present bucket might have no ESG KPIs or reporting in place and no plans for collecting future KPIs or managing reporting. Conversely, a GP in the advanced bucket might have materiality-based KPIs in constant view as part of an integrated process that includes benchmarking against targets, along with annual reporting that includes qualitative and quantitative updates on ESG considerations (e.g., portfolio company-level examples of clear linkages to value creation and sustainability outcomes).

In addition, the Framework includes a diversity, equity and inclusion (DEI) supplement and a climate supplement. Many LPs that ILPA spoke with had broken those two areas out in a similar fashion, explained Matthew D. Schey, senior director of strategic projects at ILPA and head of the Working Group. "Climate and DEI are universally material to portfolios," he said. "Regardless of sector or strategy, investments are impacted by climate change, and companies are focused on building diverse and equitable teams. We thought it best to break those areas out so we could give them the appropriate amount of additional detail."

One expert felt that despite those efforts, the environmental section of the Framework is still lacking. "It feels a bit light on the environmental side," noted Reed Smith partner Shervin Shameli, who represents both LPs and GPs. "There doesn't seem to be much detail, when compared to social and governance considerations, beyond climate-related risks."

Purpose

ILPA's goal in creating the Framework was to increase transparency about market practice and encourage dialogue between LPs and GPs. At a September 2020 ESG-focused town hall held by ILPA, only about half of the ILPA members in attendance were using a scorecard or framework to evaluate GPs based on their ESG programs, Schey recalled. "We also knew that GPs were looking for clarity on what LPs were looking for from an ESG-integration perspective," he added.

Many LPs, particularly smaller organizations, lack the resources to hire dedicated ESG professionals or create their own assessment frameworks, explained Manuela Fumarola, ESG manager for private markets at Aberdeen Standard Investments and member of the Working Group. "The United Nations Principles for Responsible Investing doesn't explain how to score ESG programs," she said. "For a smaller LP without a dedicated ESG staff member, figuring out how to assess a GP's ESG program in addition to everything else can be very tricky."

The Framework's overview states that "many best practices are still being developed." Fumarola elaborated, "I hope guidelines like this can push the industry – which has so

much potential – into delivering tangible, positive change. Two years from now, I hope we can put advanced criteria under intermediate and find that we need to create a new, more sophisticated set of advanced markers.”

Process of Creation

The Framework was developed by interviewing ILPA members about the frameworks in place at their organizations. The Working Group convened several times in H1 2021 to have “conversations centered around creating a practical document that was grounded in what LPs observe to be market practice today,” Schey noted. Once a draft was created, the Working Group reached out to a larger group of LPs and GPs for feedback.

Jurisdictional differences arose in discussions about climate and DEI. In Europe, the [Sustainable Finance Disclosure Regulation](#) (SFDR) applies to asset managers, including non-E.U. managers with a nexus to the E.U. “There was a lot of anxiety around tailoring the scorecard and getting tangible data from SFDR related to climate, which is obviously not felt by U.S. LPs because they don’t have to report on the same metrics,” Fumarola recalled. Conversely, U.S. Working Group members were much more experienced at addressing and monitoring DEI topics and therefore had more needs and desired more details on that front.

See “[How ESG Disclosure Requirements Under the E.U.’s SFDR May Impact U.S. Fund Managers](#)” (Sep. 14, 2021); and “[How PE Can Drive Diversity, Equity and Inclusion Internally, at Portfolio Companies and Industrywide](#)” (Mar. 23, 2021).

Framework’s Target Demographic

Which LPs Can Benefit

Although it is not aimed at a specific group of LPs, those that are starting or early in their ESG integration processes may benefit the most from the Framework. “It provides a powerful toolkit for those LPs to begin dialogues with and assess their GPs, as well as to understand where their investments stand relative to the market,” Schey said.

For LPs that have a more mature ESG program with an existing assessment process, the Framework can serve as a benchmark of market practice. It can also be used to lend credence and weight to LP requests because it has been endorsed by multiple organizations and its expectations are in line with the market, Fumarola suggested.

Which GPs the Framework Should Assess

Manager Size

When drafting the Framework, the Working Group discussed the resources available to GPs and how it should be tailored to a specific subset of GPs to be relevant, according to Fumarola. As the majority of ILPA members are invested in mid- to large-cap buyout PE funds, the Framework is primarily intended for assessing managers in that size and asset class. “Those managers also have the resources to make a difference,” Schey observed.

“Compared to a growth manager, it is easier for a buyout manager to implement change because it typically has a controlling position

in its investments,” Fumarola said. In addition, large managers impact many people’s lives and are capable of shifting market practice. “If you get the largest GPs to change and set industry standards, smaller GPs tend to adopt the same practices. That’s valid at the GP and portfolio company levels.”

The Framework can also be applied, however, to other-sized managers in other asset classes. “Some items might not be as applicable as others. An infrastructure fund might have a greater emphasis on environmental factors, for instance,” Shameli observed. “At the end of the day, however, a GP should still be tracking metrics, reporting on incidents, training staff, following well-drafted policies and making sure that contractual commitments are in place. That is relevant to all GPs, regardless of asset class.”

ESG Sophistication

The Framework’s utility also depends in part on how advanced a GP’s ESG program is. “For a traditional PE manager entering the ESG space or starting an ESG investment strategy, the Framework is a very good way to assess how much the manager is actually doing,” said K&L Gates partner Sonia R. Gioseffi. “The Framework is a good guide for a GP that doesn’t know much about ESG and is looking to appease its LP base because it sets out where LPs think other GPs are,” agreed Morrison & Foerster partner Susan H. Mac Cormac.

See [“Five Steps for PE Sponsors to Establish ESG Policies at Their Portfolio Companies to Suit the Present Moment”](#) (Nov. 17, 2020).

The Framework is less useful, however, for assessing GPs that have advanced ESG programs, Mac Cormac opined.

“The Framework strikes me as an LP checklist as opposed to something that would be practical for a GP to use. That is not how I approach advising GPs on their ESG programs.” The Framework could be seen as a checklist, Fumarola conceded, but a checklist that sets benchmarks is useful to LPs. “Unless an LP has a minimal level of education, it is difficult for an LP to benchmark without a checklist,” she explained.

Further to that point, Schey urged LPs and GPs to view the Framework not only as a checklist but a starting point for a series of conversations that should be part of an LP’s normal due diligence. “The Framework is not a replacement for a proper, thorough due diligence process,” he cautioned. Those conversations cannot be entered into an Excel spreadsheet, Fumarola quipped.

See [“Preparing for and Navigating Operational Due Diligence Reviews by Investors”](#) (Aug. 27, 2019); and [“Operational Due Diligence From the Fund Investor Perspective: Deal Breakers, Liquidity, Valuation, Consultants and On-Site Visits”](#) (Apr. 25, 2014).

Valuable Tool for GPs

Suitable GPs

The Framework can also be useful for GPs, particularly those just starting their ESG programs. “As we help clients develop ESG policies, we are flagging the Framework as a guide and reference for them,” said Kirkland & Ellis partner Mary Beth Houlihan. “As GPs are creating the policies that LPs are evaluating, reviewing the Framework can help them get ahead of what LPs may request.”

In addition, the Framework may also still be useful for GPs with more mature ESG programs. “A firm with an advanced ESG policy could review the Framework for any gaps in their policy,” Houlihan suggested. “GPs that have already developed their ESG policies can still look at the Framework to better inform, enhance and improve their programs,” Shameli agreed.

Ways to Use the Framework

The Framework is not theoretical but rather based on observations of market practices. “The advanced category is not an ideal. It is what we see as advanced in the market,” Fumarola stressed, echoing the overview in the Framework that identifies the stages of ESG integration in the Framework as those that LPs “are observing among [GPs] in the market today.”

“The Framework sets out to provide what a representative group of LPs observes to be market practices and is not limited to the views of one specific program or mandate,” Shey noted. “That should give comfort to GPs. We hope they find it to be a helpful resource they can use to better calibrate and understand what LPs may be looking for when it comes to ESG.”

Practical Benchmarking

In light of the Framework’s purpose, a GP’s ESG lead can check the Framework to determine how its firm measures up and use it as a roadmap for potential enhancements to its ESG policies and procedures. ILPA’s resources and updates reflect overall market movement and an increased focus on ESG, noted Kirkland & Ellis partner Nadia Murad.

Upon completing that benchmarking exercise, Houlihan observed that “many GP policies we see land between developing and intermediate. The Framework aligns with policies that we are seeing and can help GPs think about additional elements that make sense for them.” Shameli agreed that many GPs try to be in the developing to intermediate bucket before going to market.

It is worth noting, however, that GPs that self-assess their ESG programs or whose ESG programs are assessed as not present or developing should not be discouraged, Schey advised. “In many cases, LPs are looking for an alignment of mindset and shared goals. They want to see a plan and have a conversation around how a GP can move towards the intermediate and advanced buckets.”

Assessing the Framework

GP-Side Responses

General Impressions

Overall, lawyers who represent GPs considered the Framework useful. “The Framework is quite user-friendly for both LPs and GPs to use as a benchmarking, cross-checking exercise,” Shameli summarized. “It provides some clear indicators as to what efforts an LP should be seeing from its GP to move from one bucket to the next. LPs can present clear criteria to GPs from which they are asking more on the ESG front.”

Some GPs are beyond the upper boundary of the Framework, some experts said. “Bigger, sophisticated asset managers are head and shoulders out in front and leaders in some ESG areas,” Shameli said. “Not only do they have the resources to be market leaders, but they want

to be ahead of the curve on these issues,” he asserted. “The ESG leaders in the market are actually much further than what the Framework recommends,” Mac Cormac agreed.

Specific Framework Features

Mac Cormac approved of the investment process, governance and communications categories in the Framework, but found the policies category less useful. Having good policies is relatively meaningless, she opined. A GP may have a robust ESG policy on paper, but implementation is a different matter. “LPs should be looking at how the GP actually engages in deal selection and diligencing and managing portfolio companies.”

Conversely, a fund with an ESG purpose may not have an ESG policy in place, rendering that part of the Framework less useful. “A manager that is focused on minority-owned businesses or a manager whose entire investment program is related to climate technology is inherently involved in ESG investments, even though they may not have a specific ESG policy,” Gioseffi pointed out.

In addition, the absence of a dedicated impact fund or product line does not necessarily mean the firm is not considering ESG factors in its investment activities. “Some of our most ESG-sophisticated clients take the view that ESG is just good investing, integral to all of its fund products and part of the firm’s investment culture and strategy,” Murad said.

Areas for Improvement

At a high level, the Framework strikes a balance in terms of how much detail it provides, Shameli added. “It could be more detailed, yes, but having too much detail would render it less

useful because everyone is pretty time-constrained these days,” he continued. With that said, counsel for GPs suggested that the Framework could include more specific suggestions for specific asset classes.

“Advanced ESG is very dependent on industry and sector. I would want to see a grid of ESG activities that are driven by compliance requirements, impact on returns and what’s nice to have, by sector,” Mac Cormac suggested. A GP may be looking at an ESG issue because of regulatory requirements (e.g., human rights), due to portfolio company operations (e.g., climate risk resiliency in the supply chain) or to attain a competitive advantage from a marketing perspective, she explained. In each of those areas, an LP could rate the GP from early to advanced.

See [“Tactics for Incorporating Impact Investing Principles Into Private Fund Terms, Structures and Compensation”](#) (May 25, 2021).

Attaining “Advanced” Status

Significant Effort

Conceptually, no individual item in the Framework is too challenging for a GP to comply with, Shameli opined. “For example, contractual commitments in the intermediate bucket require a GP to reference commitments to ESG in the private placement memorandum and side letters,” he pointed out. “That is not difficult. A lot of GPs are doing that as a matter of course.”

Taken as a whole, however, they can be a lot of work, Shameli cautioned, even if a GP were to hire a dedicated ESG professional. For example, achieving advanced status in the Framework would require a significant amount

of resources – perhaps more than most funds would or could devote to ESG purposes, Houlihan said. “As ILPA itself emphasizes, it’s important for LPs to understand that GPs have varying levels of resources to address ESG. It may not make sense for them to be striving to be advanced or even intermediate across the board.”

Case Study: KPI Requirements

As an example of how rigorous it can be to achieve advanced status, experts detailed the difficulty of satisfying one of the Framework’s most challenging requirements: reporting and tracking KPIs.

To achieve advanced reporting, a GP would probably need one or two dedicated ESG professionals, Houlihan suggested. “LPAs do not typically contain many obligations specifically around ESG reporting,” Shameli observed. “It is becoming more common but can require considerable effort to meet. If a GP agrees to annual ESG reporting, how many issues do they need to cover? What KPIs will they use?”

Even attaining the intermediate criteria for reporting and tracking of KPIs may be difficult for certain GPs to achieve, Houlihan noted.

The Framework would assess a GP’s KPIs and reporting as intermediate if the GP had a “materiality-based process in place for determining relevant ESG KPIs” and its annual reporting included “both qualitative and quantitative updates on ESG considerations, including examples and case studies at the portfolio company level.”

Determining which KPIs to track, deciding how to track them and setting up systems for portfolio companies to report on them can take a long time, Houlihan explained. Shameli agreed, “Conceptually, it is not that difficult, but changing investment committee processes, building ESG factors into the diligence process, training staff and obtaining proper buy-in from everyone can be a tall order, especially for a GP that hasn’t done it before or hasn’t done it in a meaningful way.”

For an established manager entrenched in its work processes, changing the ethos could be “cumbersome and quite challenging,” Shameli continued. Conversely, emerging managers – especially if staffed with younger people who have been exposed to ESG and DEI issues for a significant portion of their careers – may find it easier to adapt to the criteria outlined in the Framework, he added.