FUND ESG MANAGEMENT SYSTEMS

How to design, document and implement ESG policies and procedures for private equity fund managers

INTRODUCTION

ESG management systems (ESGMS) are now well established as good practice in the private equity industry. Furthermore, the development, implementation and maintenance of an ESGMS has become a prerequisite for receiving funding from Development Finance Institutions (DFIs) and an increasing number of other investors. A well designed and properly implemented ESGMS should add value to the fund and its stakeholders by:

- Ensuring that ESG factors are part of the decision making and investment monitoring processes throughout the investment cycle.
- Providing a framework to manage ESG risks at both the fund and portfolio company level.
- Creating a framework to identify and realise value creation opportunities in portfolio companies, and integrate these into plans for organisational and operational business support.
- Providing clarity for all stakeholders on the ESG standards and sustainable business performance that the fund intends its portfolio companies to meet.
- Offering a framework to engage with key external stakeholders (e.g. Limited Partners) on ESG matters.
- Helping the fund to capture the financial value of ESG factors, record the lessons of its team's experience and demonstrate this ESG track record to new investors or new portfolio companies.

Management systems need to at least cover environmental and social (E&S), corporate governance and business integrity factors. It is up to each fund to decide whether and how to integrate these systems. Most will find it convenient to have two related, but separate, sets of management system: (i) an environmental and social management system (ESMS); and (ii) a governance and business integrity management system (GBIMS).

The two systems will intersect at different stages of the investment cycle, and information collected and managed by both sets of procedures will complement and support one another, guiding how the fund conducts its business.

For further guidance on where to start when setting up an ESGMS, see Getting started.

If you are already familiar with environmental and social management systems, see Fund Environmental and Social Management Systems.

If you are already familiar with governance and Business Integrity management systems, see Fund Governance and Business Integrity Management Systems.

GETTING STARTED

If the fund manager does not already have an ESG management system, they should consider how management of ESG issues can be integrated into their fund, or funds', operations. The guidance below is intended to help fund managers to start designing an ESG management system. For detailed guidance see Fund Environmental and Social Management System and Fund Governance and Business Integrity Management System.

Who should lead the process of designing an ESG management system?

Experience has shown that it is best to appoint at least one Senior Partner to champion and oversee the ESG management system (ESGMS), or systems, even if it is to be implemented by other team members. An ESGMS will only be effective if it is well implemented. This requires commitment from top management. It is therefore important to ensure that Senior Partners are involved from the beginning to provide the high-level commitment and strong internal support that will be necessary to ensure that: (i) ESG is appropriately integrated into the overall fund's investment strategy and operations; (ii) that ESG is taken seriously at all levels of the organisation; and (iii) any resourcing requirements are addressed as they arise.

Reviewing context and needs

Management systems need to at least cover environmental and social (E&S), corporate governance and business integrity factors. It is up to each fund to decide whether and how to integrate these systems in an ESGMS. Most will find it convenient to have two related, but separate, sets of management system: (i) an environmental and social management system (ESMS) and (ii) a governance and business integrity management system (GBIMS). When the CDC ESG Toolkit for Fund Managers refers to an ESGMS, it includes both ESMS and GBIMS regardless of whether these are two separate management systems or one integrated management system.

A good ESGMS should be tailored to the specific strategy and characteristics of each individual fund or fund manager. 'Off the shelf' solutions should be avoided. Reviewing each individual context and designing a bespoke ESMS will ensure its continued relevance and use. Fund managers should consider their priority industry sectors and regions, and the associated ESG risks, impacts and opportunities. They should also consider how priorities might change over time and how successor funds may require slightly different approaches. In addition, fund managers should review experiences to date (e.g. from existing portfolio companies or exits) and should map out and understand the role and ESG requirements of both current and possible future Limited Partners (LPs).

The ESGMS should be proportionate to the types and magnitude of ESG risks that the fund is likely to encounter in its investments. It is important to try to keep it simple, and align the scale with the complexity of the likely risks and impacts. The best management systems are not necessarily those supported by the longest and most detailed documents and procedures, but those that speak directly to the context of the fund manager's strategy, activities, priority sectors and locations and addresses pertinent risks, impacts and opportunities in adequate but not unnecessary detail.

Finally, engagement with the whole investment team will build a picture of current practice and how ESG management should best be built into any existing investment processes. Many fund managers already include ESG aspects in their day-to-day company engagement without labelling it as 'ESG'. It will be important to understand if there are any gaps in those practices and consider how to embed the new ESG practices into the culture and language of the fund.

Assigning roles and responsibilities

Each fund will be different when it comes to assigning roles and responsibilities within the investment team. It will depend on a number of factors such as team size and structure, portfolio composition and the investment model/strategy. However, any structure should include appointing a senior executive and an ESG Officer (or Officers) to take accountability and responsibility, respectively, of the ESGMS.

- ***Accountability - senior management providing support and oversight:*** There should also be oversight and support at a high level, for example a Senior Partner who sits on the IC. This person should be able to ensure adequate time, resources and commitment are being paid to ESG matters during the whole investment process and should act as a check and balance to ensure ESG matters are properly managed.
- ***Responsibility - ESG Officer(s):*** The fund manager should appoint a person with the time, experience/knowledge and/or interest to take day-to-day responsibility for ensuring ESG is implemented in practice. Fund managers may consider hiring an external ESG specialist to support the implementation of the ESGMS. In some instances (e.g. funds focusing on investment in sectors with high ESG risks and impacts) the fund may decide to hire a full time E&S Officer. When assigning the ESG Officer role it is important to ensure their work is integrated into the investment process. They should therefore have the ability to talk to company management and be involved in due diligence and monitoring and ideally, have some independence from the Deal Officer leading on the transaction.

Engaging with colleagues

An increasing number of fund managers now have a requirement or ambition to address ESG issues. Some of the funds' employees may have worked at funds with ESGMS. Other colleagues may already clearly understand the need to address ESG-related risks and opportunities through their own experience of deals with exposure to potentially high risk sectors, such as extractives. There may also be members of the team who do not yet fully understand how ESG can be integrated into a successful investment process. In developing an ESGMS, it is vital that Investment Officers understand the ESG business case, ensure that the procedures introduced dovetail with existing processes, and make sure that they are effectively implemented.

Engaging with LPs

Many LPs (and all Development Finance Institution (DFI) LPs) will have clear expectations of, and relevant experience around, ESG management and performance as a result of the funds they already invest in. They should usually therefore be able to provide guidance regarding ESG management. Engaging early on with LPs to understand what their requirements and expectations are is key. Early engagement with LPs also allows the fund to benefit from LPs' expertise and guidance and maximise consistency and alignment of ESG requirements across investors/LPs.

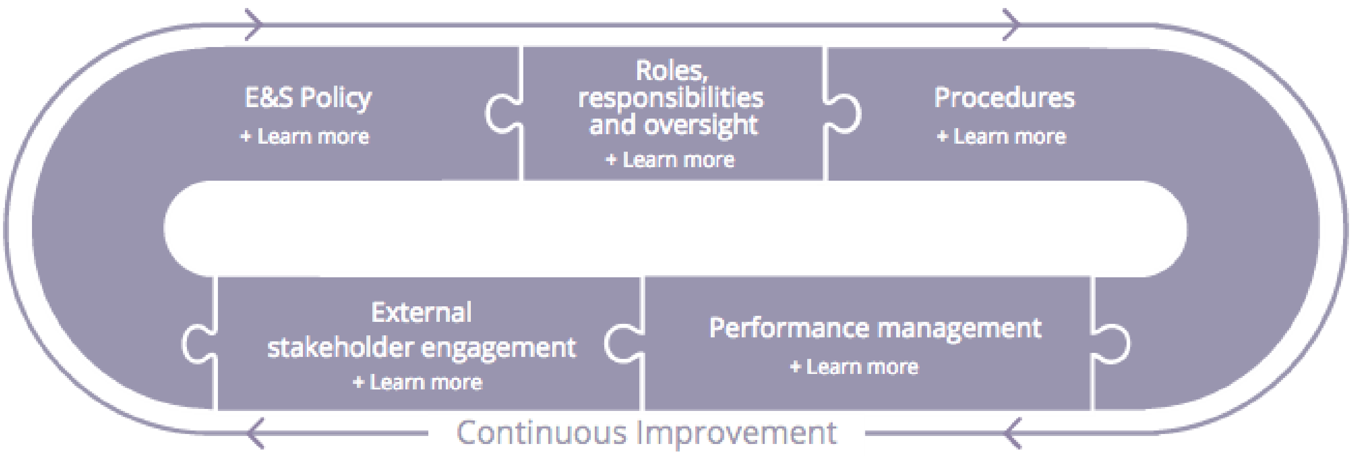
Deciding when and how to engage consultants

All funds will need to consider whether and when to use consultants. In some cases external advice may be needed to help develop and implement the ESGMS or, for example, for specific transaction support. Some fund managers have compiled a database of preferred specialists to be called upon for specific input to identify risks or opportunities during the due diligence or ownership phases. It can be useful to determine when external expertise should be sought (e.g. for investments triggering specific ESG risks or impacts, or those in particularly complex or challenging sectors or geographies).

Continuous improvement

Any effective ESGMS is one that provides clear guidance to address ESG risks, impacts and opportunities across the portfolio and entire investment cycle, while remaining flexible enough to accommodate improved processes and changes to the portfolio or investment process (e.g. a change in the fund's sector focus). It is important to regularly revisit the system (e.g. once a year) to make adjustments and improvements over time and to implement the lessons learnt from applying the tools and using the system. There should be a clear approval process for any resulting updates to the system.

FUND ENVIRONMENTAL AND SOCIAL MANAGEMENT SYSTEMS



Introduction

All funds need to have an environmental and social management system (ESMS) commensurate with the level of environmental and social (E&S) risks and impacts associated with current and potential portfolio companies and that takes into account the fund manager's capacity and structure. It should be noted that an ESMS is more than a set of documents. It is the way in which a fund manager ensures that ESG aspects are well managed. The documents are just a part of the fund management system.

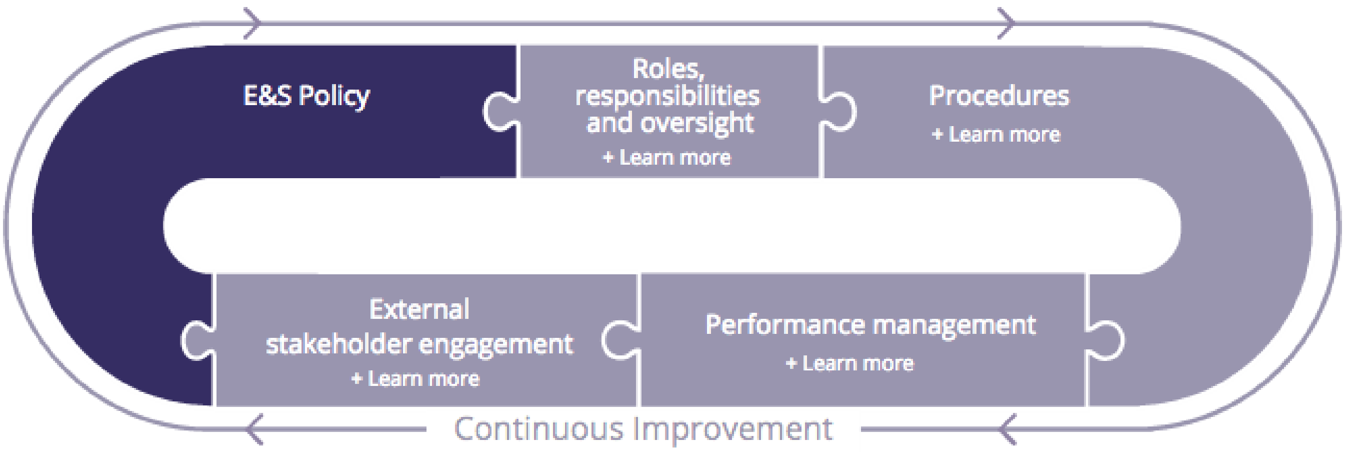
This section provides guidance on designing and implementing an ESMS.

A fund's ESMS should include the following key elements:

- ***E&S policy***: The framework for the whole management system. The policy should articulate the objectives and principles that guide the fund manager/fund, applicable requirements for the fund and portfolio companies, and accountability and responsibility for its implementation.
- ***Roles, responsibilities and oversight:*** A clear definition of who is responsible for developing and driving the ESMS and stating who will participate in each element of its implementation.

- ***Procedures***: What needs to be done at the various stages of the investment cycle. These should be underpinned by specific tools to ensure consistent application.
- ***Performance management:*** A periodic review to refine and improve the systems. The fund will need to consider how, when, and by whom these reviews are undertaken.
- ***External communication:*** The fund should consider the variety of channels available to communicate with its Limited Partners (LPs) and other stakeholders about how the management system is functioning alongside the E&S performance of the portfolio.

E&S POLICY



1. Overview

All fund managers should have an E&S policy that:

- Clearly articulates the fund's investment principles and values from an E&S perspective and conveys the fund manager's strategy, ambitions and business culture with regard to managing E&S risks, impacts and opportunities.
- Explains the framework of the whole E&S management system, including the E&S standards the fund manager will apply and expects portfolio companies to meet (e.g. local regulations, International Labour Organization (ILO) Core Labour Conventions and International Finance Corporation (IFC) Performance Standards, where applicable).
- Includes or refers to a list of the activities in which the fund/fund manager will not invest (the fund's 'Exclusion List').
- Highlights the fund manager's/fund's intentions with respect to identifying and realising business opportunities relating to E&S themes.
- Specify the individuals who will be accountable and responsible for the implementation of the policy.
- Meets the E&S requirements as set out by LPs in the Limited Partners Agreement/side letter that governs the fund.

- Is communicated and available to the fund management team, portfolio companies and current and prospective LPs.
- Is approved by a representative of the senior management team and dated.

2. Guidance and advice

2.1 Developing an approach

The most effective and realistic E&S policies evolve where fund managers have properly considered the types and significance of the E&S issues to which the fund will be exposed, their own market positioning, their specific circumstances, and the resources available internally to develop their policies and procedures. It is also important to consider investors' priorities and expectations and align the direction of the fund's policy and practices with those of key stakeholders.

2.2 Elements of a good policy

Good policies typically contain or address the following:

- A summary of the fund's beliefs and stance on E&S matters and responsible investment. This explains briefly how the fund's values and practices are aligned with, and contribute to, the organisation's overall mission and objectives, as well as its approach to addressing challenges.
- A brief statement about the scope and applicability of the policy (e.g. define whether the policy applies to all funds managed by the fund manager or whether it will be retroactively applied to funds already in existence and/or those assets already in the portfolio?)
- A clear statement regarding the sectors and activities in which the fund manager will not invest ('Exclusion List').
- A clear statement regarding E&S norms and standards that the fund will follow and to which it will hold its portfolio companies. This will often be structured as a hierarchy whereby certain requirements will apply to all portfolio companies. For example: a list of excluded activities and the requirement to comply with local law and/or the ILO Core Labour Conventions, with other standards (such as IFC Performance Standards) applied when they are relevant.
- A commitment to work realistically and pragmatically towards the application of these standards over time and a description of how the fund intends to achieve this goal despite the challenges it may face.
- A reference to internationally recognised initiatives, principles or standards that the fund manager has adopted or committed to follow (e.g. United Nations (UN) Principles for Responsible Investment (PRI)).
- A summary of how the policy will be applied and how progress will be reported.
- The policy should be clear and understandable.
- The policy should be signed by top-level management (to demonstrate the fund manager's commitment) and dated. The policy (and the rest of the ESMS) should be communicated to the fund's team and revisited with appropriate regularity to ensure it remains relevant and up to date. There should be a process for revising the policy and other components of the ESMS. Changes to the ESMS may need sign-off by LPs.

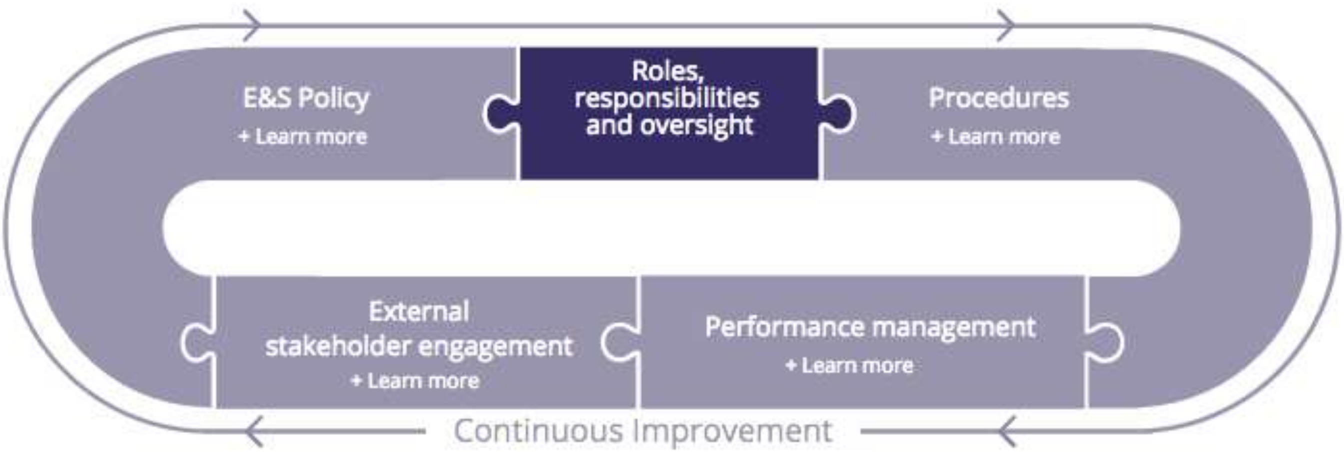
2.3 Communicating the policy

Policy document should be visible and adequately communicated and explained to all members of the fund management team, and should be easily accessible and made prominent (e.g. published on the fund manager's intranet, in the LP zone of its website and potentially disclosed publicly online).

Consideration should also be given to whether and how the policy is communicated externally. It is also important to consider who might be interested in the policy – potential and current portfolio companies, as well as investors – and then make the policy easily accessible to them.

During fund raising, it is important for the fund to disclose enough information on its ESMS to allow potential LPs to assess whether their approaches are aligned. A well-conceived policy and ESMS will signal E&S commitment to potential investors.

ROLES, RESPONSIBILITIES AND OVERSIGHT



1. Overview

There is no ‘best’ or standard way to organise roles and responsibilities; every fund is different. The structure of the ESMS should be aligned to the fund’s commitments and capacity to address E&S matters. Common elements of good practice are:

- Clearly assign and document accountability for oversight of the ESMS to one senior staff member, ideally an Investment Committee (IC) member.
- Clearly assign and document responsibility for ensuring implementation of the ESMS to one person with sufficient knowledge, commitment and seniority to ensure its effective application. Cascade responsibilities through the fund team.
- Establish day-to-day working practices to ensure the ESMS is implemented effectively.
- Ensure sufficient resources and training are provided.
- Put in place effective checks and balances to ensure adequate ESMS implementation and to avoid conflicts of interest.
- Develop a robust training programme to ensure sufficient understanding of E&S matters.

2. Guidance and advice

Fund managers are advised to develop a flow chart/table (see table below) and accompanying documentation to indicate how implementation of the ESMS aligns with the operational investment process (i.e. who is responsible for ensuring E&S matters are addressed at each stage of the investment cycle: identification, screening, due diligence, decision making and portfolio management). It can also indicate how E&S responsibilities have been assigned and where specific expert E&S input (internal or external) is likely to be required.

2.1 Accountability for the ESMS

Ideally, accountability for the ESMS should reside with a senior executive of the fund (e.g. a Senior Partner or voting member of the IC). The role of the senior executive includes approving the policy, leading and ensuring its proper implementation, ensuring E&S matters are discussed at IC meetings and reporting to the Board and investors. When assigning this role, the fund structure, culture and processes, as well as the existing time commitments of the individual(s), should be taken into account in order to ensure that adequate time is devoted to driving the ESMS. These people should be knowledgeable about E&S matters and how to address them.

A senior staff member (ideally an IC voting member) should also lead the evaluation of the adequacy of due diligence for each deal for the IC, in order to provide a 'check and balance' mechanism. This may be the same person who is accountable for the ESMS or another IC member.

If it is not possible to allocate accountability to a senior IC member with E&S experience, the fund should try to identify a senior staff member who has a personal interest in E&S matters and find a way to provide that person with training or give this person access to independent advice.

2.2 Responsibility for the ESMS

To ensure effective implementation of ESMS, an E&S Officer(s) who has sufficient influence, capacity and commitment should be appointed. The E&S Officer is responsible for operationalising the ESMS (i.e. day-to-day implementation). This includes ensuring that the ESMS is applied consistently and effectively, undertaking reviews of the system and acting as the main contact point for companies, fund staff and LPs for E&S matters. The E&S Officer should also take responsibility (as relevant) for external and internal E&S communications.

This person should have a reasonable understanding of E&S matters, but does not necessarily need to be an E&S specialist. In addition, the E&S Officer can have another role, provided that role does not conflict with the E&S responsibilities. The level of experience required, and whether the role needs to be full time, will depend upon the level of the E&S issues the fund is likely to encounter, the size and type of fund, and how responsibility for E&S implementation is allocated. Some fund managers employ an E&S specialist to cover several funds.

2.3 Resources and training

ESMS development and implementation will require resources (budget and staff) and thought should be given to who will manage these resources. It is also important to ensure that appropriate training is provided to the investment team and, where appropriate, the E&S Officer.

It should be noted that, in some instances, particularly when the fund manager has limited E&S expertise or capacity and may be exposed to significant E&S risks and impacts, LPs may require capacity improvements such as targeted E&S training, recruitment of additional staff, or mentoring by external E&S experts.

2.4 Day-to-day implementation of the ESMS

Experience shows that funds that have most effectively implemented an ESMS have well-trained and fully-committed staff, who understand that consideration of E&S matters needs to be integrated into their investment activities and responsibilities, and whose objectives and remuneration covers E&S management.

At a minimum, an E&S Officer should be tasked with management of the system (ideally this person should have some separation from the deal leader to ensure objective E&S assessment). In funds investing in medium-high/high risk sectors or activities, this E&S Officer will typically be a specialist.

ESMS implementation will involve several teams. As a result, it is important that the E&S Officer coordinates collective efforts from the various teams. Investment Officers will typically have an important role in the implementation of the ESMS and, hence, should understand the business case for E&S management. Additionally, the E&S Officer will ideally have experience in successfully engaging with portfolio companies around E&S management. Where such E&S responsibilities are being introduced to investment staff, it is important to offer training, mentoring and/or other support.

The fund manager should also consider whether its representatives on the Boards (or Advisory Committees) of portfolio companies have sufficient understanding of and experience with E&S matters, to engage with company management on E&S performance. Where this is not the case, capacity building could be of value, or, in some cases, the fund should consider bringing in external expertise.

2.5 Checks and balances

As noted previously, it is important to put in place appropriate checks and balances to ensure that E&S matters are assessed properly throughout the investment cycle, in accordance with the fund's procedures. Depending on the fund's specific characteristics, fund managers may adopt different approaches taking into account the fund structure and size, the E&S risk profile, the investment strategy of the fund, LP expectations and requirements, and the ambitions, requirements and objectives outlined in the fund's policy. A good principle to observe is that the E&S assessment presented to the IC and other relevant Committees is conducted, written and reviewed, by someone independent from the Investment Officer, both prior to investment and during ownership.

The IC typically provides an important 'check and balance' role. Having senior people on the IC with the knowledge and commitment to evaluate E&S matters ensures that E&S aspects are effectively considered in each investment.

Fund managers should ensure that information on the E&S performance of portfolio companies is also subject to adequate checks and balances. Therefore, the IC (and/or other committees) should oversee E&S performance of portfolio companies during ownership. Fund managers should consider whether the IC and/other committees would benefit from E&S training.

2.6 Training

When designing and implementing training sessions and programmes, fund managers should:

- Identify the specific requirement for training and who within the fund management team requires this training.
- Define the content of the training.

- Decide how the training will be delivered.
- Decide who will deliver the training.
- Establish a system to evaluate the effectiveness of the training programme.

Developing an appropriate training programme will significantly contribute to implementation of the ESMS. A training programme should not be a one-off event. Instead, it should include the sharing of experiences and lessons learnt, as well as more specialised training as the ESMS becomes better established.

Generally, all staff within the fund should participate in some level of capacity building to understand E&S dimensions and how they relate to investment, as well as on the actual functioning of the ESMS and the procedures involved. Professionals with direct company contact should be able to confidently and clearly articulate the fund's E&S requirements, as well as identify potential E&S risks and opportunities.

2.6.1 Running in-house training

The advantage of in-house training is that the whole investment team can be brought together to discuss deals and lessons learned without confidentiality concerns. In-house training can be run either by experienced in-house ESG staff or commissioned through consultancies. Experience has shown that interactive training, including case studies and evaluation of real life deals, is more successful than generic and/or academic training.

The design of the training program should take the fund's portfolio and strategy and deal team's time constraints, key concerns and needs into account. Some funds have found it useful to integrate E&S training into general fund training arrangements, particularly induction training, and to add E&S modules whenever other training is given. In addition, planning for regular refresher training, or at least discussion groups, assists in keeping the ESMS at the front of mind.

An effective training programme may not rely entirely on internal or external training sessions, but may also include some on-the-job training (e.g. shadowing a consultant to site visits). Since there may not be relevant training programmes available on all topics, this can be a good way to increase knowledge and awareness. Similarly, if some team members have more experience regarding E&S issues than others, setting up a peer-to-peer learning system should be encouraged.

2.6.2 Learning from experience

In developing training programs and resources, it is important to take the context and experiences of the fund and its team into account. Engagement with all team members following a training exercise is necessary to assess the adequacy of the session. It can be interesting to follow up several months post-training session to see which elements of the training had the smallest or the greatest impact. It is also useful to keep an eye on what training for the private equity (PE) sector is generally available in the market and which ESG topics are currently trending.

2.6.3 Staying informed and keeping up to date

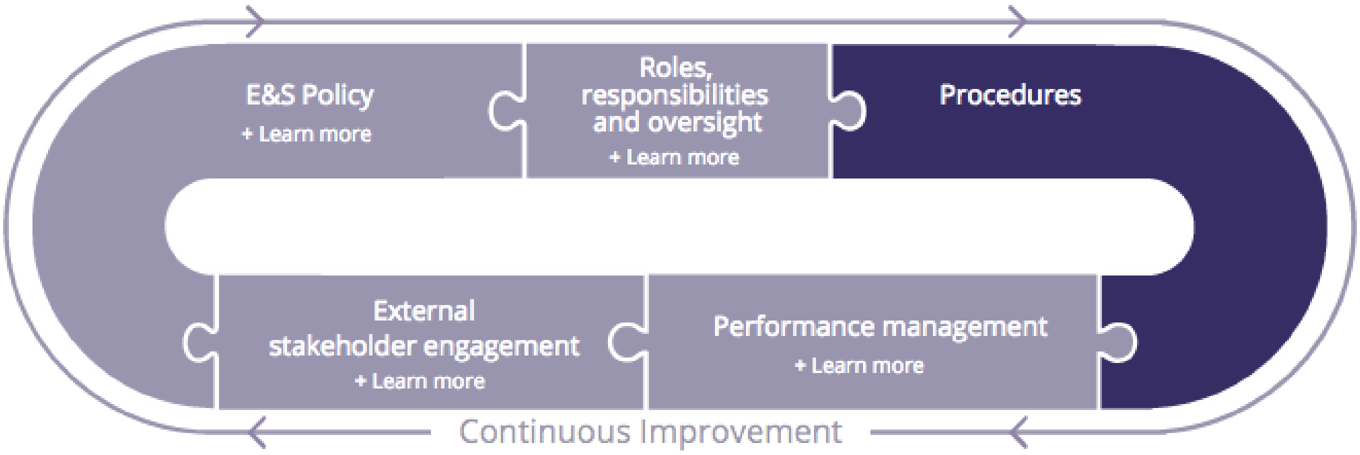
Participating in regional PE networks or initiatives such as the East Africa Venture Capital Corporation (EAVCA), African Private Equity and Venture Capital Association (AVCA), Emerging Markets Private Equity Association (EMPEA) and PRI has the advantage of keeping professionals with E&S responsibilities up to date with regulatory developments, changes in approach to E&S management, key issues emerging, and corresponding tools to manage these. It can be useful to not only focus on networks or bodies relevant to the private equity sector, but also to participate in initiatives in the sectors on which the fund focuses.

2.6.4 Capacity building initiatives/tools

Several Development Finance Institutions (DFIs) and organisations offer ESG capacity building for PE. Examples include:

- **CDC:** Offers a variety of training initiatives (introductory workshops, specialist technical workshops and training on the use of this Toolkit), as well as more detailed and tailored ESG training responding to specific requests from fund managers. Contact esgtoolkit@cdcgroup.com for more information.
- **German Investment and Development Corporation (DEG):** Delivers capacity building through partnerships with regional consultancies that offer bespoke advisory programs and mentoring to funds, including those with no prior exposure to ESG issues. DEG also contributes to regional training and capacity building under initiatives such as the Sustainable Banking Principles in Nigeria and the Sustainability Finance Initiative of the Kenya Bankers Association. Contact regional DEG investment staff for further information.
- **International Finance Corporation (IFC):** Offers periodic regional training for the financial sector broadly, and sometimes for funds specifically. Contact regional offices for further information. IFC also has a simple online resource introducing the ESG business case and categorisation of deals.
- **FMO:** Delivers periodic regional workshops on ESG risk management to the financial sector and to private equity. Contact regional FMO officers for further information, and see FMO ESG tools. FMO also contributes to regional training and capacity building initiatives delivered through DFI partnerships in Africa and Asia and offers capacity building to first time fund managers through consultants under a co-funding model with the fund manager.
- **UN PRI:** Offers training to investment professionals globally through the PRI Academy. This course is designed to educate investment professionals about ESG issues and how they impact business and investment decision-making.
- **UNEP FI (United Nations Environment Programme Finance Initiative)**: Offers online training on environmental and social risk assessment for the financial sector, as well as one-day, face-to-face introductory, sector-specific or advanced training sessions. The latter are often convened by national financial sector bodies such as banks or banking associations, but can also be delivered in house. Contact carolina.lopez@unep.org.
- **USSIF (The Forum for Sustainable and Responsible Investment):** Offers online and live courses on the fundamentals of sustainable and responsible investment to PE funds through its Centre for Sustainable Investment Education.
- **GIIN (Global Impact Investing Network):** Offers training in various aspects of impact investing, some of which are relevant to PE investors.

PROCEDURES



1. Overview

All funds should have documented practical procedures that set out how they operationalise their E&S policy on a day-to-day basis, from screening prospective investments, to the ownership and monitoring stage and through to exit. Procedures help to ensure that a consistent approach is applied across the investment cycle and the fund's portfolio, and to define roles and responsibilities. Above all, E&S procedures should be practical and consistent with the fund's operational procedures. Simplicity and pragmatism should be prioritised over complexity and bureaucracy.

2. Guidance and advice

Procedures and accompanying tools (see graph below) should be designed to ensure that E&S matters are considered throughout the investment cycle. Ideally these procedures should be integrated within investment operating procedures and into existing management systems, rather than in a separate system.

2.1 Developing effective and pragmatic procedures

Procedures should cover:

- How E&S aspects will be addressed at each stage of the investment cycle.
- Roles and responsibilities at each stage of the investment cycle.
- Approvals, oversight and performance management, including 'checks and balances'.
- How the fund will communicate/report on E&S matters to LPs.
- Grievance mechanisms, where appropriate.

Experienced fund managers have found that it is typically easier to develop E&S procedures once investment procedures are in place, and to integrate these E&S procedures into existing processes. In this respect, process flow diagrams can assist in ensuring a clear overview of how and where the E&S procedures apply to the investment cycle and in articulating key roles and responsibilities for each of these stages. There should be a clear explanation of what needs to be achieved at each stage of the investment cycle. Appendices containing templates to be used and adapted during screening, due diligence and monitoring could significantly help to ensure efficient and consistent implementation of the ESMS (checklists and other tools are provided in Downloads/Reference Materials). The procedures should take into account the E&S requirements and expectations of LPs.

Above all, the aim for E&S procedures should be that they help the deal team and E&S Officer to manage potential E&S risks, impacts and opportunities, throughout the life of an investment, rather than being seen as a compliance or 'tick box' exercise.

2.2 Procedures for integrating E&S management into the investment cycle

Operating procedures should be prepared for the various activities to be performed throughout the investment cycle, clearly highlighting roles and responsibilities. Procedures may include templates that can be adapted on a deal-by-deal basis. A good procedure manual will typically cover the points included in the table below. Procedures, as with the rest of the ESMS, can be structured in different ways. The ultimate goal is to produce something that is helpful and appropriate for the fund to manage ESG in the investment cycle.

Screening and E&S categorisation: Robust procedures at screening will contribute to a more efficient due diligence process. Procedures and/or tools would typically cover: (i) identification of material breaches of the fund's policy and Exclusions List; (ii) identification of key E&S issues; (iii) categorisation of inherent E&S risks/impact; and (iv) planning of due diligence.

***Due diligence*:** Significant guidance is required at this stage. Procedures and tools would typically cover: (i) assessment of the transaction's E&S risks, impacts and opportunities; (ii) assessment of the company's compliance against applicable standards/requirements, including guidance on the information to be reviewed; (iii) confirmation of E&S inherent risk categorisation; (iv) site visits; (v) assessment of the company's commitment, capacity and track-record; (v) preparation of due diligence reports; and (vi) engagement of consultants (where appropriate).

Investment decision: Ensuring that all investment decisions are supported by appropriate due diligence documentation, including an E&S section in IC papers/Investment Memorandum. This enables IC members to understand and discuss E&S matters at each meeting. Procedures and tools providing guidance on how to prepare IC papers (i.e. investment proposal to IC and IC minutes) should be developed.

Investment agreement: Ensuring that appropriate E&S representations, warranties and covenants are incorporated in each investment agreement is of vital importance. It is advisable to develop a set of standard E&S terms and conditions, which could be adapted to each investment based on the findings of due diligence (e.g. where E&S gaps have been identified, an E&S Action Plan (ESAP) should be included in the legal documentation).

Ownership and monitoring: Fund managers should not only take E&S matters into account during due diligence. Continued engagement with portfolio companies post-investment is key to ensuring that E&S management is integrated into the portfolio company's operations, that ESAPs are effectively implemented and that E&S opportunities realised. Procedures and tools would typically cover: (i) engagement with investee companies during ownership; (ii) monitoring of companies' E&S performance, ESAP implementation and compliance with investment agreement requirements; and (iii) management of unforeseen events (e.g. serious accidents).

Additionally, procedures on how to engage with/report to LPs should be developed. These should include regular monitoring and reporting on material events such as serious accidents involving/affecting investee companies (e.g. Fatalities).

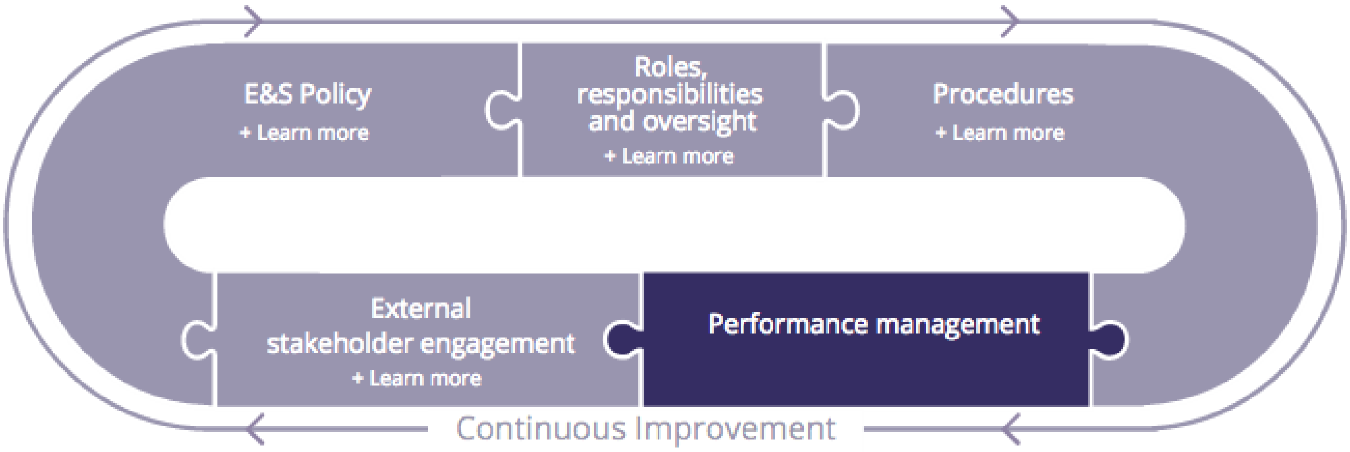
Some fund managers have templates to guide portfolio data collation and reporting to LPs and, if applicable, other stakeholders. In some cases, LPs will provide a reporting template to guide fund managers (see example - CDC's reporting template). The goal should be to provide adequate detail and clear communication of actual, rather than perceived, performance, without resorting to a 'tick box' approach. Templates should be designed to be easily understood by those utilising them. Follow-up and feedback on the reports will also be required. Some fund managers also use Advisory Committee meetings to highlight progress made on E&S matters, or include it on investor site visits to portfolio companies.

Roles and responsibilities: It is necessary to clearly assign roles and responsibilities for all aspects of ESMS implementation, from management of E&S aspects within portfolio companies and oversight of the implementation, through to the design and application of E&S procedures within the fund itself, including reporting and disclosure to stakeholders.

Performance management and review: It is important to have periodic oversight and a regular performance review to assess the continued relevance and efficacy of the ESMS and to make adjustments and improvements. The procedures should identify who is responsible for the ESMS performance review and how any corrective actions and/or changes to the ESMS will be agreed and approved.

Procedures for grievance mechanisms: Fund managers should implement a mechanism to enable third parties to raise their grievances. Fund managers should investigate these grievances and assess whether any further action should be taken.

PERFORMANCE MANAGEMENT



1. Overview

All funds should have an effective system for monitoring and periodically reviewing the adequacy of their ESMS. In order to do this, appropriate records need to be kept, documenting the process followed for each investment and the progress made or challenges encountered. Reviewing the successes and challenges faced when implementing the ESMS can reveal important lessons and insights to improve the system and make it more effective. Continuous improvement is a key component of the ESMS.

When assigning roles and responsibilities funds should be clear about who will conduct performance reviews and how corrective actions/changes to the ESMS will be implemented and approved.

2. Guidance and advice

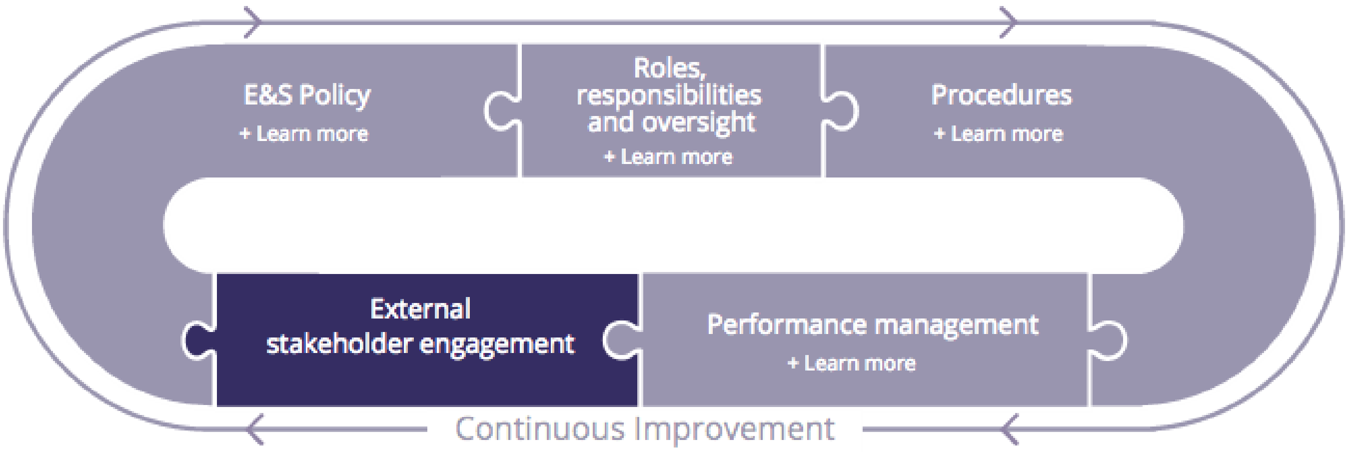
Fund managers should monitor the adequacy of their ESMS to ensure it is appropriate to deliver the fund's strategy and commitments, manage ESG matters and meet stakeholders' (e.g. LPs) expectations and requirements. Any deficiencies, including lack of capacity/expertise, should be addressed within a reasonable timeframe. Responsibility for monitoring the ESMS adequacy should be clearly identified.

2.1 Elements of performance management

Performance management comprises:

- Evaluation of the E&S policy against changes in the fund's investment strategy, priority sectors, geographies, or shareholdings. In light of such changes, fund managers should evaluate whether the ESMS is still relevant, achievable and applicable, and revise the ESMS as appropriate.
- Performance evaluations of people assigned responsibility for managing and implementing the ESMS. Fund managers should assess whether the people responsible for the implementation of the ESMS still have the capacity and commitment to continue successfully driving implementation of the system.
- Processes to assess how thoroughly and consistently E&S issues are addressed by Investment/Portfolio Officers. Check whether screening memos, due diligence reports, investment memos, investment agreements and monitoring reports contain adequate and relevant information, with clear follow-up of key issues between documents demonstrating progress over time. It is useful to compare levels of detail between Investment/Portfolio Officers and deal teams to identify any gaps or inconsistencies.
- Mechanisms to get feedback from the various teams, which should follow the ESMS.
- Process to approve changes to the ESMS (may require LPs approval).
- Process to ensure the implementation of corrective actions to improve the system and to address the limitations/development areas identified. For example:
  - Additional training and awareness raising;
  - Improving the oversight mechanisms;
  - The inclusion of E&S performance in personal objectives;
  - Improved tools and guidance;
  - Additional use of consultants to advise the team;
  - Peer-to-peer learning within the team.
- Assessment of global trends in managing E&S issues in sectors in which the fund is active, as this will help to assess whether the ESMS should be revised and/or whether additional training should be provided. For example, an increased focus on transparency in the extractives sector could suggest that portfolios need to be more actively monitored in these sectors.

EXTERNAL STAKEHOLDER ENGAGEMENT



1. Overview

All funds should report to LPs, (and potentially to other stakeholders), on the implementation and progress of their ESMS and the E&S performance of their portfolio companies. It is fairly standard for this to be an annual report, although some fund managers also include E&S aspects in their quarterly reports. Many funds also increasingly use other communication channels to discuss E&S matters in a more proactive manner including *ad hoc* calls or emails, Advisory Committee meetings, investor days and inviting investors on site visits etc. These help to build a mutually supportive relationship between the fund and its LPs.

2. Guidance and advice

2.1 Disclosure of information during fund raising

During fundraising, it is important that the fund manager discloses sufficient information on its E&S management to potential LPs, as this could attract LPs and/or expedite their due diligence process. A well-conceived E&S policy and a good ESMS will signal to a potential investor that the fund's approach and commitment are solid. Where the fund manager has a track record with other funds, information demonstrating how it has supported and enhanced its portfolio companies' management of E&S risks can offer good starting points for engagement with LPs.

Investors may ask to see examples of due diligence, E&S coverage in legal agreements and ESG reports to LPs. As such, ensuring that progress on priorities identified during due diligence can be clearly followed through the document trail is important in demonstrating an effective system.

However, some fund managers may not have fully designed an ESMS when they contact LPs. In these cases, LPs may be able to provide guidance to fund managers on how to develop it in alignment with LPs' expectations.

2.2 Reporting to Limited Partners

Many LPs (and all DFI LPs) require fund managers to report regularly (at least annually) on the E&S performance of their portfolios and of the funds themselves. The purpose of this reporting is twofold. Firstly, it allows LPs to assess how E&S improvements have been implemented within portfolio companies, what challenges may have been encountered, and how these were addressed. Secondly, it offers an opportunity for LPs to check that the fund is still being managed in line with the E&S commitments made by the fund, and/or whether there have been any material changes to the fund's portfolio, strategy, management or focal sectors to justify a change in scope of, or approach to, E&S management. Reporting should also address the steps the fund has taken to ensure continued implementation of its ESMS, such as additional training, recruitment and partnerships with external advisors or re-assignment of internal responsibilities.

Reporting by fund managers to LPs typically incorporates the following information:

- Update on the implementation of the E&S policy, procedures and fund terms, as well as any changes or deviations. It should also outline plans for the following reporting period, including matters such as whether a review of the ESMS is planned and whether a training programme will be delivered.
- For each portfolio company, a summary of the following:
    - The situation at initial investment. This should include the E&S risks, impacts and opportunities identified, a summary of any ESAP, the inherent risk rating assigned to the company, and a judgement regarding the quality of the company's E&S management systems or ability to manage its E&S risks.
    - An update of progress during the reporting period, including milestones achieved (particularly those on the ESAP agreed with the fund manager), challenges encountered, responses to challenges, and any performance indicators that are being tracked such as number of lost time incidents, volume of water used, emissions of certain pollutants etc.
    - A summary of the priority actions for the following year. It should be easy to follow up on priority actions from the report one year to the next, with an update on progress made over the year and any discrepancies explained.
- It can also be useful to highlight the fund's role in helping the company to achieve milestones or identify new business opportunities, as well as highlight the effect of any sector or geographic trends.
- Discussion of incidents or accidents that occurred in portfolio companies over the reporting period, and whether/how these were appropriately reported, investigated and mitigated, and how further incidents were prevented, including evidence to substantiate this.
- Leading funds will discuss E&S-related developments that have occurred in the reporting period that could affect the implementation of the ESMS by the fund and the fund's management of portfolio companies. For example, heightened strike action in a particular sector to which the fund is exposed or political tensions regarding land or water rights.

Leading funds might also highlight initiatives they have undertaken to share best practice between companies, such as hosting training for them or facilitating the sharing of expertise between companies in related sectors.

An example of a reporting template could be found here.

2.3 Ongoing engagement with Limited Partners

Fund managers should consider contacting LPs to get guidance on E&S management and have regular meetings or calls to discuss E&S performance. Ongoing communication enables a constructive and trusting relationship to be built up between fund manager and LP that can be mutually beneficial. Many DFI LPs, including CDC, welcome being contacted for advice regarding E&S matters (e.g. challenges faced by fund managers). DFIs can draw upon their experience and may be able to suggest solutions or possible ways forward — or put the fund in touch with others who might be able to help.

An increasing number of fund managers incorporate E&S into their mainstream LP communications, including Advisory Committee meetings, investor days, site visits and quarterly reports, as E&S is increasingly seen as a material feature of the fund performance that should be reported together with other information. LPs typically welcome this.

2.4 Public disclosure

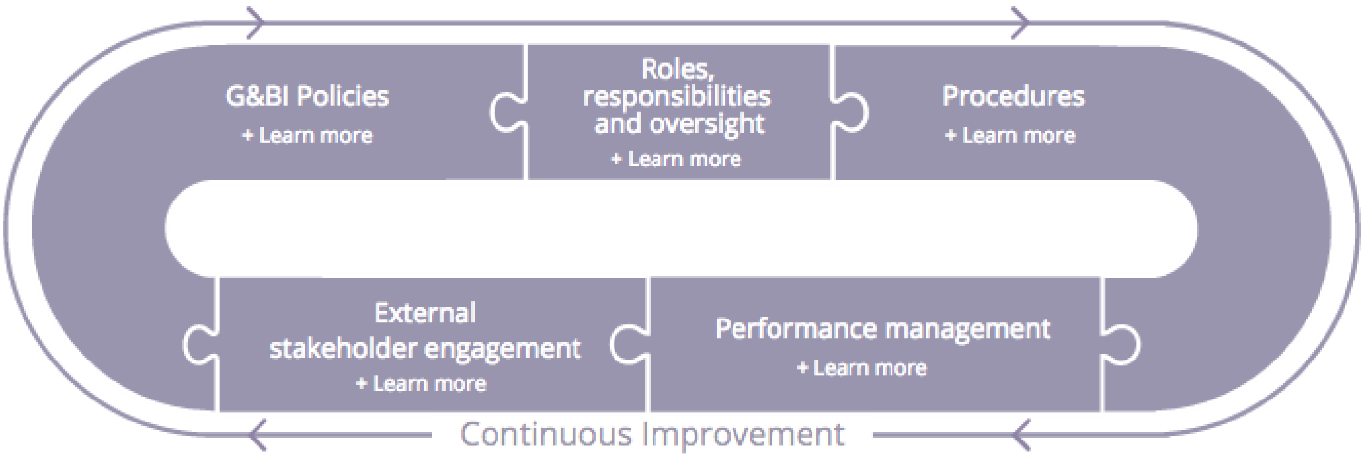
Some LPs now actively encourage the funds in which they invest to report publicly on their approach to managing E&S issues in their portfolios in order to encourage public transparency in the investment sector. This is particularly the case in certain domiciles that have introduced recommendations or requirements for fuller disclosure, such as the UK Stewardship Code and the Code for Responsible Investment in Southern Africa (CRISA).

This information should be included either in annual reports already prepared by the fund and/or on the fund manager's website. Reports should focus on providing a balanced, objective and complete snapshot of the fund's investments. To contextualise the reporting, information on the fund's ESMS should be included. Additionally, examples of how these E&S values and approaches have contributed to improving performance or mitigating risk in portfolio companies should be given.

2.5 Reporting under PRI

Membership of bodies or international initiatives may also trigger reporting requirements. For example, adoption of the UN PRI requires (after a one-year grace period) annual reporting against its framework, including mandatory public disclosure of some information.

GOVERNANCE AND BUSINESS INTEGRITY MANAGEMENT SYSTEMS



Introduction

All funds need to have a governance and business integrity management system (GBIMS) commensurate with the level of governance, business integrity and compliance (G&BI) risk, and the impacts of those risks associated with current and potential portfolio companies. The GBIMS will need to take into account the fund manager's capacity and structure. It should be noted that GBIMS is more than a set of documents. It is the way in which a fund manager ensures that ESG aspects are well managed. The documents are just a part of the fund management system.

This section provides guidance on designing and implementing a GBIMS.

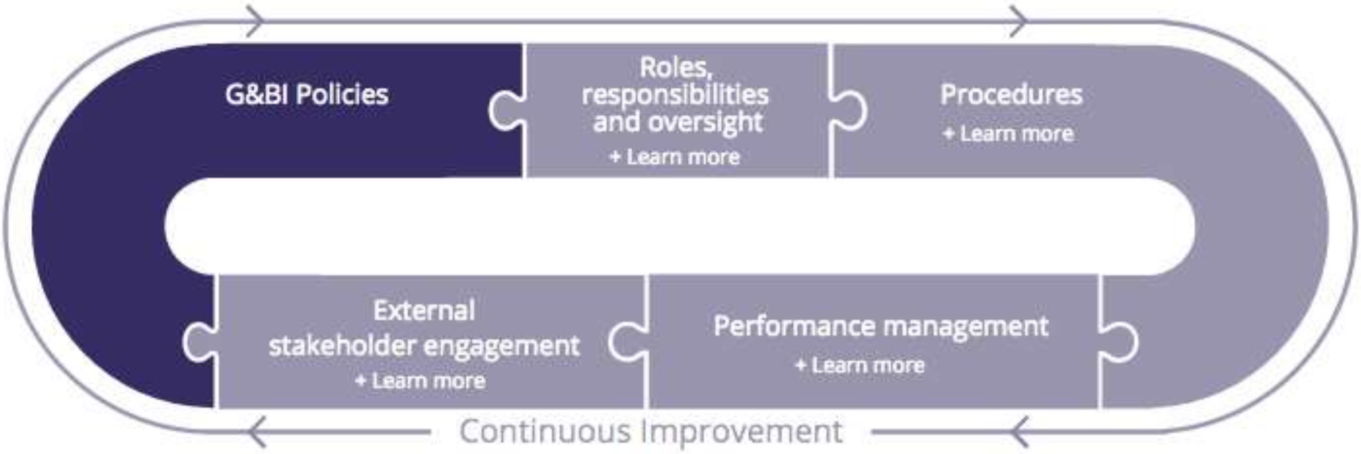
In this section, and throughout the CDC Toolkit for Fund Managers G&BI covers:

- Corporate governance practices.
- Anti-corruption policies and procedures.
- Whistleblower policies and procedures.
- Compliance policies and practices, particularly Anti-Money Laundering, Know Your Customer (KYC) and sanctions.

A fund's GBIMS should include the following key elements:

- ***Policies*: The fund manager's policies form the framework for the whole management system. The policies should clearly and simply set out the objectives and principles that guide the fund manager/fund, applicable requirements for the fund and portfolio companies, and those accountable and responsible for their implementation.
- ***Roles, responsibilities and oversight:*** A clear definition of who is responsible for developing and driving the policies behind the GBIMS and stating who will participate in each element of its implementation. CDC believes that there should always be a nominated individual responsible for each of the policies.
- ***Procedures***: What needs to be done at the various stages of the investment cycle. These should be underpinned by specific tools to ensure consistent application.
- ***Performance management:*** A periodic review to refine and improve the systems. The fund will need to consider how, when and by whom these reviews are undertaken and who they are reported to.
- ***External communication:*** The fund should consider the variety of channels available to communicate with its Limited Partners (LPs) and other stakeholders about how the policies and management system is functioning alongside the G&BI performance of the portfolio.

G&BI POLICIES



1. Overview

All fund managers should have G&BI policies that:

- Clearly articulate the fund’s investment principles and values from a G&BI perspective and conveys the fund manager’s strategy, ambitions and business culture with regard to managing G&BI risks, impacts and opportunities.
- Explain the framework of the whole G&BI management system, including the G&BI standards the fund manager will apply and expects portfolio companies to meet (e.g. local regulations and international best practices).
- Highlight the fund manager’s/fund’s intentions with respect to identifying and realising business opportunities relating to G&BI themes.
- Specify the individuals who will be accountable and responsible for the implementation of the policies.
- Meet the G&BI requirements as set out by LPs in the Limited Partners Agreement /side letter that governs the fund.
- Are communicated and available to the fund management team, portfolio companies and current and prospective LPs.
- Are approved by the senior management team and dated.

2. Guidance and advice

2.1 Developing an approach

The most effective and realistic G&BI policies evolve where fund managers have properly considered the types and significance of the G&BI risks to which the fund will be exposed, their own market positioning, their specific circumstances, and the resources available internally to develop their policies and procedures. It is also important to consider investors' priorities and expectations and align the direction of the fund's policies and practices with those of key stakeholders.

2.2 Elements of good policies

Good policies typically contain or address the following:

- A summary of the fund's beliefs and stance on G&BI matters and responsible investment. This explains briefly how the fund's values and practices are aligned with, and contribute to, the organisation's overall mission and objectives, as well as its approach to addressing challenges.
- A brief statement about the scope and applicability of the policies (e.g. define policies, whether the policies apply to all funds managed by the fund manager or whether they will be retroactively applied to funds already in existence and/or those assets already in the portfolio?)
- A clear statement regarding G&BI norms and standards that the fund will follow and which it will hold its portfolio companies to. This may be structured as a hierarchy whereby certain requirements will apply to all portfolio companies.
- A commitment to work realistically and pragmatically towards the application of these standards over time and a description of how the fund intends to achieve this goal despite the challenges it may face.
- A reference to internationally recognised initiatives, principles or standards that the fund manager has adopted or committed to follow (e.g. United Nations-supported Principles for Responsible Investment (PRI)).
- A summary of how the policies will be applied and how progress will be reported.
- The policies should be clear and understandable.
- The policies should be formally adopted by top-level management (to demonstrate the fund manager's commitment) and dated. The policies (and the rest of the GBIMS) should be communicated to the fund's team and revisited with appropriate regularity to ensure it remains relevant and up to date. There should be a process for revising the policies and other components of the GBIMS. Changes to the GBIMS may need sign-off by LPs.

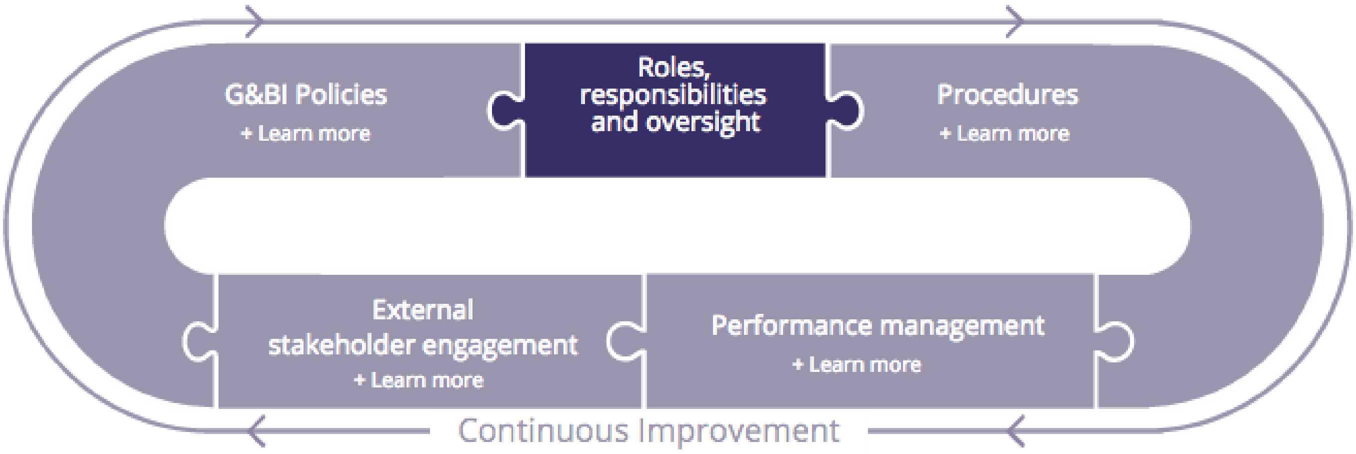
2.3 Communicating the policies

Policy documents should be visible, and adequately communicated and explained, to all members of the fund management team, and should be easily accessible and made prominent (e.g. published on the fund manager's intranet, in the LP zone of its website and potentially disclosed publicly online).

Consideration should also be given to whether and how the policies are communicated externally. It is also important to consider who might be interested in the policies – potential and current portfolio companies, as well as investors – and then make the policies easily accessible to them.

During fund raising, it is important for the fund to disclose enough information on its GBIMS to allow potential LPs to assess whether their approaches are aligned. A well-conceived set of policies and a clear GBIMS will signal G&BI commitments to potential investors.

ROLES, RESPONSIBILITIES AND OVERSIGHT



1. Overview

There is no ‘best’ or standard way to organise roles and responsibilities; every fund and every portfolio company will be different. The structure of the GBIMS should be aligned to the fund’s commitment and capacity to address G&BI matters. Common elements of good practice are:

- Clearly assign and document accountability for oversight of the policies which make up the GBIMS to appropriate senior staff members, ideally an Investment Committee (IC) member.
- Clearly assign and document responsibility for ensuring implementation of the policies to staff with sufficient knowledge, commitment and seniority to ensure their effective application. Cascade responsibilities through the fund team.
- Establish day-to-day working practices to ensure the GBIMS is implemented effectively.
- Ensure sufficient resources and training are provided.
- Put in place effective checks and balances to ensure adequate implementation and to avoid conflicts of interest.
- Develop a robust training programme to ensure sufficient understanding of G&BI matters.

2. Guidance and advice

Fund managers may wish to develop a flow chart/table (see graph below) and accompanying documentation to indicate how implementation of the GBIMS aligns with the operational investment process (i.e. who is responsible for ensuring G&BI matters are addressed at each stage of the investment cycle: identification, screening, due diligence, decision making and portfolio management). It can also indicate how G&BI responsibilities have been assigned and where specific expert G&BI input (internal or external) is likely to be required.

2.1 Accountability for the GBIMS

Ideally, accountability for each of the G&BI policies should reside with a senior executive of the fund (e.g. a Senior Partner or voting member of the IC). The role of the senior executive includes approving, developing and promoting the policies, leading and ensuring their proper implementation, ensuring relevant G&BI matters are discussed at IC meetings and reporting to the Board and investors. When assigning these roles, the fund structure, culture and processes, as well as the existing time commitments of the individual(s), should be taken into account in order to ensure that adequate time is devoted to driving the GBIMS. These people should be knowledgeable about their relevant G&BI matter and how to address it. It is likely that within a small organisation that these various roles will be held by one person.

A senior staff member (ideally an IC voting member) should also lead the evaluation of the adequacy of due diligence for each deal for the IC, in order to provide a 'check and balance' mechanism (see 'Checks and balances' below). This may be the same person who is accountable for the GBIMS or another IC member.

If it is not possible to allocate accountability to a senior IC member with relevant experience, the fund should try to identify a senior staff member who has a personal interest in G&BI matters and find a way to provide that person with training or give this person access to independent advice.

2.2 Responsibility for the GBIMS

To ensure effective implementation of the GBIMS, a G&BI Officer(s) with sufficient independence, influence, capacity and commitment should be appointed. The G&BI Officer is responsible for operationalising their particular policies (i.e. day-to-day implementation). This includes ensuring that relevant parts of the GBIMS are applied consistently and effectively, undertaking reviews of the system and acting as the main contact point for companies, fund staff and LPs for their particular G&BI matters. The G&BI Officer should also takeresponsibility (as relevant) for external and internal G&BI communications.

This person should have a reasonable understanding of G&BI matters, but does not necessarily need to be a G&BI specialist. In addition, the G&BI Officer can have another role, provided that role does not conflict with their G&BI responsibilities. The level of experience required and whether the role needs to be full time will depend upon the level of the G&BI issues the fund is likely to encounter, the size and type of fund, and how responsibility for G&BI implementation is allocated. Some fund managers employ a G&BI specialist to cover several funds.

2.3 Resources and training

GBIMS development and implementation will require resources (budget and staff), and thought should be given to who will manage these resources. It is also important to ensure that appropriate training is provided to the investment team and, where appropriate, the G&BI Officer.

It should be noted that, in some instances, particularly when the fund manager has limited G&BI expertise or capacity and may be exposed to significant G&BI risks and impacts, LPs may require capacity improvements such as targeted G&BI training, recruitment of additional staff, or mentoring by external G&BI experts.

2.4 Day-to-day implementation of the GBIMS

Experience shows that funds that have most effectively implemented a GBIMS have well-trained and fully-committed staff, who understand that consideration of G&BI matters needs to be integrated into their investment activities and responsibilities, and whose objectives and remuneration covers G&BI management.

At a minimum, the G&BI Officer should be tasked with management of the system, (ideally there should be some separation from the deal leader to ensure objective G&BI assessment).

GBIMS implementation will involve several teams including G&BI Officers, investment Officers, counsel and in some instances, external consultants. As a result, it is important that a G&BI Officer coordinates collective efforts from the various teams. Investment Officers will typically have an important role in the implementation of the GBIMS and, hence, should understand the business case for G&BI. Additionally, the G&BI Officer will ideally have experience in successfully engaging with portfolio companies around G&BI management. Where such G&BI responsibilities are being introduced to investment staff, it is important to offer training, mentoring and/or other support.

The fund manager should also consider whether its representatives on the Boards (or Advisory Committees) of portfolio companies have sufficient understanding of, and experience with, G&BI matters, to engage with company management on G&BI performance.

Where this is not the case, capacity building could be of value or, in some cases, the fund should consider bringing in external expertise.

2.5 Checks and balances

As noted previously, it is important to put in place appropriate checks and balances to ensure that G&BI matters are assessed properly throughout the investment cycle, in accordance with the fund's procedures. Depending on the fund's specific characteristics, fund managers may adopt different approaches taking into account the fund structure and size, the G&BI risk profile, the investment strategy of the fund, LP expectations and requirements, and, the ambitions, requirements and objectives outlined in the policies. A good principle to observe is that the G&BI assessment presented to IC and, as applicable, to other relevant committees is conducted, written, and reviewed, by someone independent from the leading Investment/Portfolio Officer.

The IC typically provides an important 'check and balance' role. Having senior people on the IC with the knowledge of G&BI issues and the ability and commitment to evaluate G&BI matters ensures that these aspects are effectively considered in each investment.

Fund managers should ensure that information on the G&BI performance of portfolio companies is also subject to adequate checks and balances. Therefore the IC or other committees should oversee G&BI performance of portfolio companies during ownership. Fund managers should also consider whether members of the IC and/or committees would benefit from G&BI training.

2.6 Training

When designing and implementing training sessions and programmes, fund managers should:

- Identify the specific requirements for training and who within the fund management team requires this training..
- Define the content of the training.
- Decide how the training will be delivered.
- Decide who will deliver the training.
- Establish a system to evaluate the effectiveness of the training programme.

Developing an appropriate training programme will significantly contribute to implementation of the GBIMS. A training programme should not be a one-off event. Instead, it should include the sharing of experiences and lessons learnt, as well as more specialised training as the policies that make up the GBIMS become better established.

Generally, all staff within the fund should participate in some level of capacity building to understand G&BI dimensions and how they relate to investment, as well as on the actual functioning of the GBIMS and the procedures involved. Professionals with direct company contact should be able to confidently and clearly articulate the fund's G&BI requirements, as well as identify potential G&BI risks and opportunities.

2.6.1 Running in-house training

The advantage of in-house training is that the whole investment team can be brought together to discuss G&BI issues and lessons learned without confidentiality concerns. In-house training can be run either by experienced in-house staff or commissioned through consultancies. Experience has shown that interactive training, including case studies and evaluation of real life deals, is more successful than generic and/or academic training.

The design of the training program should take the fund's portfolio and strategy and deal team's time constraints, key concerns and needs into account. Some funds have found it useful to integrate G&BI training into general fund training arrangements, particularly induction training, and to add G&BI modules whenever other training is given. In addition, planning for regular refresher training, or at least discussion groups, assists in keeping the GBIMS at the front of mind.

An effective training programme may not rely entirely on internal or external training sessions, but may also include some on-the-job training. Since there may not be relevant training programmes available on all topics, this can be a good way to increase knowledge and awareness. Similarly, if some team members have more experience regarding G&BI issues than others, setting up a peer-to-peer learning system should be encouraged.

2.6.2 Learning from experience

In developing training programs and resources, it is important to take the context and experiences of the fund and its team into account. Engagement with all team members following a training exercise is necessary to assess the adequacy of the session. It can be interesting to follow up several months post- training session to see which elements of the training had the smallest or the greatest impact. It is also useful to keep an eye on what training for the private equity (PE) sector is generally available in the market and which ESG topics are currently “trending”.

2.6.3 Staying informed and keeping up to date

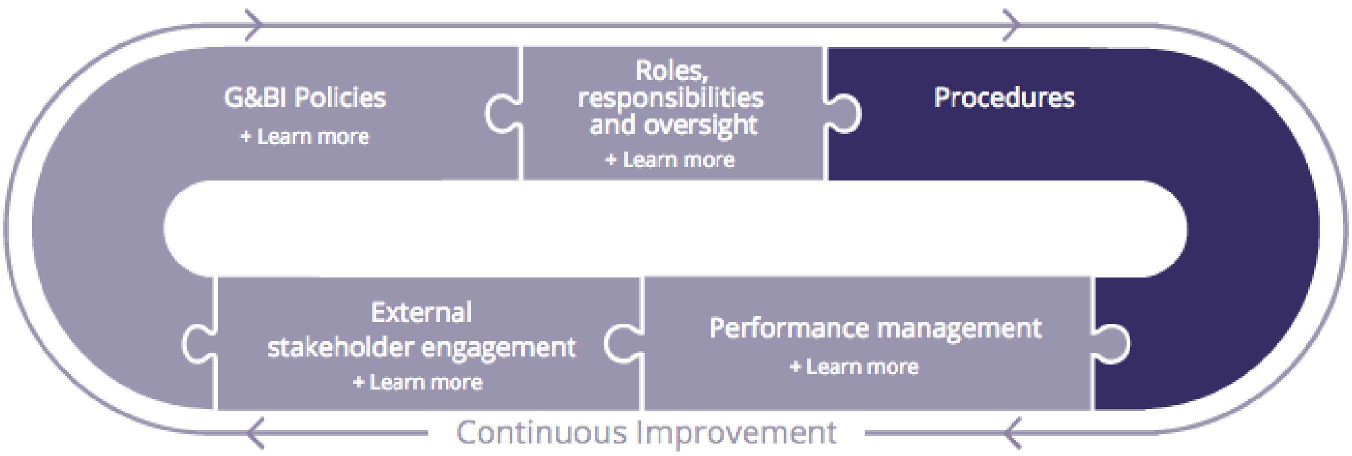
Participating in regional PE networks or initiatives such as East Africa Venture Capital Corporation (EAVCA), African Private Equity and Venture Capital Association (AVCA), Emerging Markets Private Equity Association (EMPEA) and PRI has the advantage of keeping professionals with G&BI responsibilities up to date with regulatory developments, changes in approach to G&BI management, key issues emerging and corresponding tools to manage these. It can be useful to not only focus on networks or bodies relevant to the private equity sector, but also to participate in initiatives in sectors on which the fund focuses.

2.6.4 Capacity building initiatives/tools:

Several **Development Finance Institutions** (DFIs) and organisations offer ESG **capacity building** for PE. Examples include:

- **CDC*:*** Offers a variety of training initiatives (introductory workshops, specialist technical workshops and training on the use of this Toolkit), as well as more detailed and tailored ESG training responding to specific requests from fund managers. Contact esgtoolkit@cdcgroup.com for more information.
- **German Investment and Development Corporation (DEG):** Delivers capacity building through partnerships with regional consultancies that offer bespoke advisory programs and mentoring to funds, including those with no prior exposure to ESG issues. DEG also contributes to regional training and capacity building under initiatives such as the Sustainable Banking Principles in Nigeria and the Sustainability Finance Initiative of the Kenya Bankers Association. Contact regional DEG investment staff for further information.
- **International Finance Corporation (IFC):** Offers periodic regional training for the financial sector broadly, and sometimes for funds specifically. Contact regional offices for further information. Certain regions also benefit from longer sector-wide training initiatives such as the Environmental Performance and Market Development programme that was conducted in Nigeria and Vietnam. IFC also has an online resource introducing the ESG business case and categorisation of deals.
- **Netherlands Development Finance Company (FMO):** Delivers periodic regional workshops on ESG risk management to the financial sector and to private equity. Contact regional FMO Officers for further information, and see FMO ESG tools. FMO also contributes to regional training and capacity building initiatives delivered through DFI partnerships in Africa and Asia. It also offers capacity building to first time fund managers through consultants under a co-funding model with the fund manager.
- **PRI*:*** Offers training to investment professionals globally through the PRI Academy. The coursework is designed to educate investment professionals about ESG issues and how they impact business and investment decision-making.
- **The Forum for Sustainable and Responsible Investment (US SIF):** Offers online and live courses on the fundamentals of sustainable and responsible investment to PE funds through its Centre for Sustainable Investment Education US SIF.
- **Global Impact Investing Network (GIIN):** Offers training in various aspects of impact investing, some of which are relevant to PE investors.

PROCEDURES



1. Overview

All funds should have documented practical procedures that set out how they operationalise their G&BI policies on a day-to-day basis, from screening prospective investments to the ownership and monitoring stage through to exit. Procedures help to ensure that a consistent approach is applied across the investment cycle and the fund's portfolio, and to define roles and responsibilities. Above all, G&BI procedures should be practical and consistent with the fund's operational procedures. Simplicity and pragmatism should be prioritised over complexity and bureaucracy.

2. Guidance and advice

Procedures and accompanying tools (see image below) should be designed to ensure that G&BI matters are considered throughout the investment cycle. Ideally these procedures should be integrated within investment operating procedures and into existing management systems, rather than in a separate system.

2.1 Developing effective and pragmatic procedures:

Procedures should cover:

- How G&BI aspects will be *addressed at each stage* of the investment cycle e.g. due diligence.
- Roles and responsibilities at each stage of the investment cycle.
- Approvals, oversight and performance management including 'checks and balances'.
- How the fund will communicate/report on G&BI matters to LPs.
- Grievance mechanisms, where appropriate.

Experienced fund managers have found that it is typically easier to develop G&BI procedures once investment procedures are in place, and to integrate these G&BI procedures into existing processes. In this respect, process flow diagrams can assist in ensuring a clear overview of how and where the G&BI procedures apply to the investment cycle and in articulating key roles and responsibilities for each of these stages. There should be a clear explanation of what needs to be achieved at each stage of the investment cycle. Appendices containing templates to be used and adapted during screening, due diligence and monitoring could significantly help to ensure efficient and consistent implementation of the GBIMS (checklists and other tools are provided Downloads & Reference Materials). The procedures should take into account the G&BI requirements and expectations of LPs.

Above all, the aim for G&BI procedures should be that they help the deal team and G&BI Officer(s) to evaluate and manage potential G&BI risks and opportunities throughout the life of an investment. They must not be seen as a compliance or 'tick box' exercise.

2.2 Procedures for integrating G&BI management into the investment cycle

Operating procedures should be prepared for the various activities to be performed throughout the investment cycle, clearly highlighting roles and responsibilities. Procedures may include templates that can be adapted on a deal-by-deal basis. A good procedure manual will typically cover the points included in the table below. Procedures, as with the rest of the GBIMS, can be structured in different ways. The ultimate goal is to produce something that is helpful and appropriate for the fund to manage ESG in the Investment Cycle.

Screening: Robust procedures at screening will contribute to a more efficient due diligence process. Procedures and/or tools would typically cover: (i) identification of material breaches of the fund's policy and Exclusions List; (ii) identification of key E&S issues; and (iii) planning of due diligence.

Due diligence: Significant guidance is required at this stage. Procedures and tools would typically cover: (i) assessment of the transaction's G&BI risks, impacts and opportunities; (ii) assessment of a company's compliance against applicable standards/requirements, including guidance on the information to be reviewed; (iii) site visits; (iv) assessment of the company's commitment, capacity and track-record; (v) preparation of due diligence reports; and (vi) engagement of appropriate consultants (where appropriate).

Investment decision: Ensuring that all investment decisions are supported by appropriate due diligence documentation, including a G&BI section in IC papers/Investment Memorandum. This enables IC members to understand and discuss G&BI matters at each meeting. Procedures and tools providing guidance on how to prepare IC papers (i.e. investment proposal to IC and IC minutes) should be developed.

Investment agreement: Ensuring that appropriate G&BI representations, warranties and covenants are incorporated in each investment agreement is of vital importance. It is advisable to develop a set of standard G&BI terms and conditions, which are then adapted to each investment based on the findings of due diligence (e.g. where material gaps are identified, an ESG Action Plan should be included in the legal documentation).

Ownership and monitoring: Fund managers should not only take G&BI matters into account during due diligence. Continued engagement with portfolio companies post-investment is key to ensuring that G&BI management is integrated into the portfolio company's operations, that ESG Action Plans are effectively implemented and that G&BI opportunities are realised. Procedures and tools would typically cover: (i) engagement with investee companies during ownership; (ii) monitoring of companies' G&BI performance, ESG Action Plan implementation and compliance with investment agreement requirements; and (iii) management of unforeseen events (e.g. corruption issues).

Additionally, procedures on how to engage with/report to LPs should be developed. These should include regular monitoring and reporting on material events such as unforeseen events or relevant situations involving/affecting investee companies.

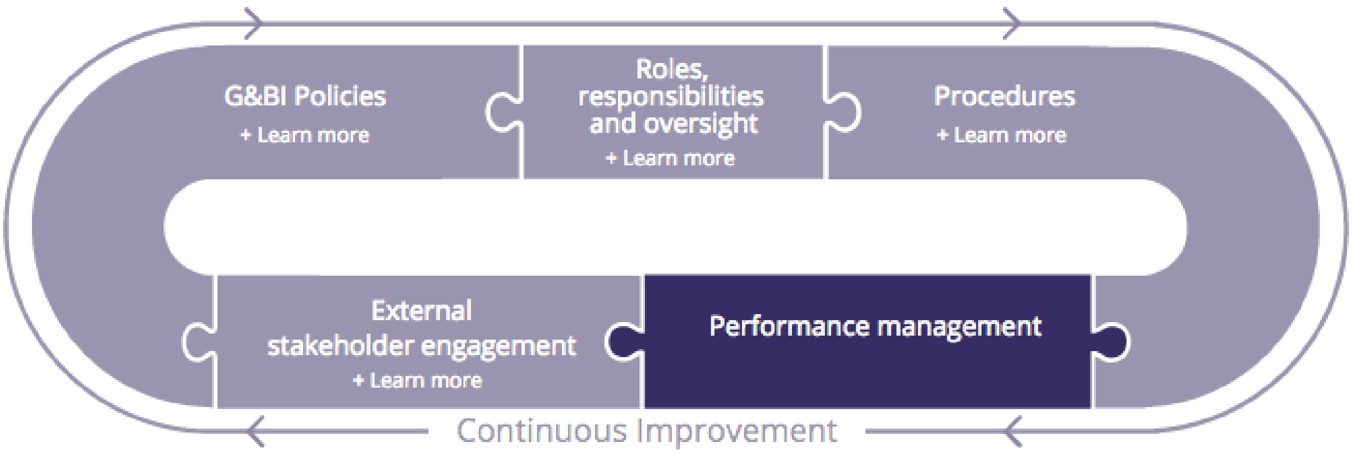
Some fund managers have templates to guide portfolio data collation and reporting to LPs and, if applicable, other stakeholders. In some cases, LPs will provide a reporting template to guide fund managers (see example - CDC's reporting template). The goal should be to provide adequate detail and clear communication of actual, rather than perceived, performance, without resorting to a 'tick box' approach. Templates should be designed to be easily understood by those utilising them. Follow-up and feedback on the reports will also be required. Some fund managers also use Advisory Committee meetings to highlight progress made on G&BI matters, or include it on investor site visits to portfolio companies.

Roles and responsibilities: It is necessary to clearly assign roles and responsibilities for all aspects of GBIMS implementation from management of G&BI aspects within portfolio companies and oversight of the implementation, through to the design and application of E&S procedures within the fund itself, including reporting and disclosure to stakeholders.

Performance management and review: It is important to have periodic oversight a regular and performance review to assess the continued relevance and efficacy of the GBIMS and to make adjustments and improvements. The procedures should identify who is responsible for the GBIMS performance review and how any corrective actions and/or changes to the GBIMS will be agreed and approved.

Procedures for grievance mechanisms: Fund managers should implement a mechanism to enable third parties to raise their grievances. Fund managers should investigate these grievances and assess whether any further action should be taken.

PERFORMANCE MANAGEMENT



Performance management

1. Overview

All funds should have an effective system for monitoring and periodically reviewing the adequacy of their GBIMS. In order to do this, appropriate records need to be kept, documenting the process followed for each investment and the progress made or challenges encountered. Reviewing the successes and challenges faced when implementing the GBIMS can reveal important lessons and insights to improve the system and make it more effective. Continuous improvement is a key component of the GBIMS.

When assigning roles and responsibilities funds should be clear about who will conduct performance reviews and how corrective actions/changes to the ESMS will be implemented and approved.

2. Guidance and advice

Fund managers should monitor the adequacy and performance of their GBIMS and the underlying policies to understand the extent to which they are meeting their own objectives and strategy, meeting stakeholders’ (e.g. LPs) expectations and requirements, and contributing to the performance of their funds and the companies in which they are invested.

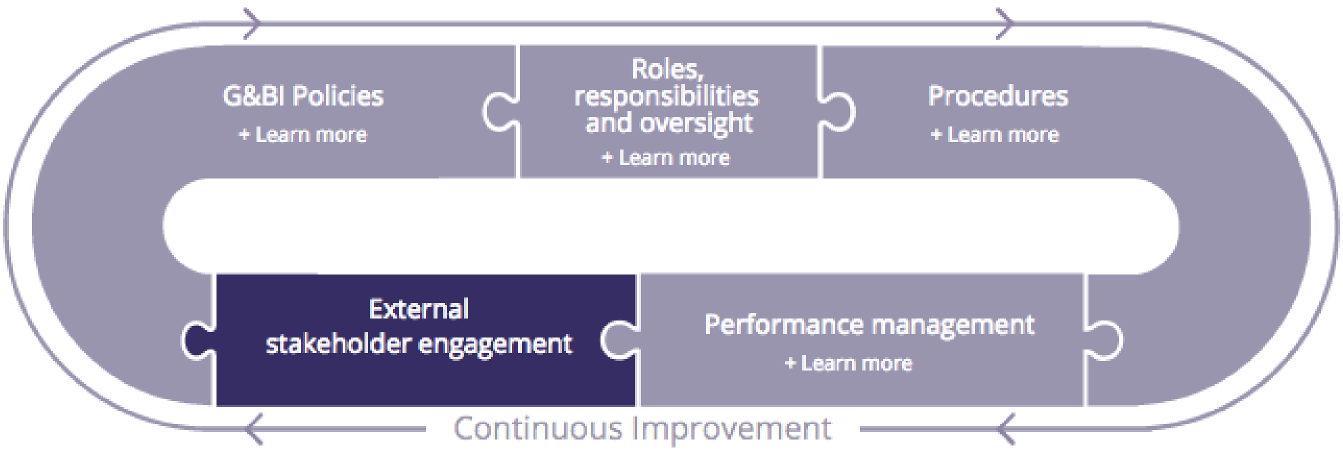
Periodic review of the efficacy of the GBIMS and G&BI policies allows the fund to assess whether it needs to adjust its ambitions or goals, invest more in capacity building of its investment team, or remedy any matters that are either posing obstacles or being by-passed within the investment cycle. Responsibility for monitoring the efficacy and efficiency of the policies should be clearly identified in the policies and GBIMS documentation.

2.1 Elements of performance management

Performance management comprises:

- Evaluation of the G&BI policies against changes in the fund's investment strategy, priority sectors, geographies or shareholding. In light of such changes fund managers should evaluate whether the GBIMS is still relevant, achievable and applicable and revise the policies as appropriate.
- Performance evaluations of people assigned responsibility for managing and implementing GBIMS. Fund managers should assess whether the people responsible for the implementation of the GBIMS and its underlying policies have the capacity and commitment to continue successfully driving implementation of the system.
- Processes to assess how thoroughly and consistently G&BI issues are addressed by Investment/Portfolio Officers. It will be necessary to check whether screening memos, due diligence reports, investment memos, investment agreements and monitoring reports contain adequate and relevant information, an assessment of G&BI risks and clear follow-up of key issues between documents demonstrating progress over time. It is useful to compare levels of detail between Investment/Portfolio Officers and deal teams to identify any gaps or inconsistencies.
- Mechanisms to get feedback from the various teams, which should follow the G&BI policies.
- A process to approve changes to the GBIMS (may require LPs approval).
- A process to ensure the implementation of corrective actions to improve the system and to address the limitations/development areas identified. For example:
    - Additional training and awareness raising;
    - Improving the oversight mechanisms;
    - The inclusion of G&BI performance metrics in personal objectives;
    - Improved tools and guidance;
    - Additional use of consultants to advise the team;
    - Peer-to-peer learning within the team.
- Assessment of global trends in managing G&BI issues in sectors in which the fund is active, as this will help to assess whether the G&BI should be revised and/or whether additional training should be provided. For example, increased focus on transparency in the extractives sector could suggest that portfolios need to be more actively monitored in these sectors. Related templates or guidance documents in use may also need to be revised.

EXTERNAL STAKEHOLDER ENGAGEMENT



1. Overview

All funds should report to LPs, (and potentially to other stakeholders), on the implementation and progress of their G&BI policies and the G&BI performance of their portfolio companies. It is fairly standard for this to be an annual report, although some fund managers also include G&BI aspects in their quarterly reports. Many funds also increasingly use other communication channels to discuss G&BI matters in a more proactive manner including *ad hoc* calls or emails, Advisory Committee meetings, investor days and inviting investors on site visits, etc. These help to build a mutually supportive relationship between the fund and its LPs.

2. Guidance and advice

2.1 Disclosure of information during fund raising

During fundraising, it is important that the fund manager discloses sufficient information on its G&BI management to potential LPs, as this could attract LPs and/or expedite their due diligence process. A well-executed set of G&BI policies and a good GBIMS will signal to a potential investor that the fund's approach and commitment are solid. Where the fund manager has a track record with other funds, information demonstrating how it has supported and enhanced its portfolio companies' management of G&BI risks can offer good starting points for engagement with LPs. Investors may ask to see examples of due diligence, G&BI coverage in legal agreements and ESG reports to LPs. As such, ensuring that progress on priorities identified during due diligence can be clearly followed through the document trail is important to in demonstrating an effective system.

However, some fund managers may not have fully designed a GBIMS when they contact LPs. In these cases, LPs may be able to provide guidance to fund managers on how to develop it in alignment with LPs' expectations.

2.2 Reporting to Limited Partners

Many LPs (and all DFI LPs) require fund managers to report regularly (at least annually) on the G&BI performance of their portfolios and of the funds themselves. The purpose of this reporting is twofold. Firstly, it allows LPs to assess how G&BI improvements have been implemented within portfolio companies, what challenges may have been encountered, and how these were addressed. Secondly, it offers an opportunity for LPs to check that the fund is still being managed in line with the G&BI commitments made by the fund, and/or whether there have been any material changes to the fund's portfolio, strategy, management or focal sectors to justify a change in scope of, or approach to, G&BI management. Reporting should also address the steps the fund has taken to ensure continued implementation of its GBIMS, such as additional training, recruitment and partnerships with external advisors or re-assignment of internal responsibilities.

Reporting by fund managers to LPs typically incorporate the following information:

- Update on the implementation of the G&BI policies, procedures and fund terms, as well as any changes or deviations. It should also outline plans for the following reporting period, including matters such as whether a review of the GBIMS is planned and whether a training programme will be delivered.
- For each portfolio company, a summary of the following:
    - The situation at investment: This should include the G&BI risks/issues identified, a summary of any ESG Action Plan and a judgement regarding the quality of the company's G&BI management systems or ability to manage its G&BI.
    - An update of progress during the reporting period, including milestones achieved (particularly those ESG Action Plan agreed with the fund manager), challenges encountered, responses to challenges, and any performance indicators that are being tracked.
    - A summary of the priority actions for the following year. It should be easy to follow up priority actions from the report one year to the next, with an to the update on progress made over the year, with any discrepancies explained.
- It can also be useful to highlight the fund's role in helping the company to achieve milestones or identify new business opportunities, as well as highlight the effect of any sector or geographic trends.
- Discussion of incidents that have occurred in portfolio companies over the reporting period, and whether/how these were appropriately reported, investigated and, mitigated and how further incidents were prevented, including evidence to substantiate this.
- Leading funds will discuss G&BI-related developments that have occurred in the reporting period that could affect the implementation of the GBIMS by the fund and the fund's management of portfolio companies. Leading funds might also highlight initiatives they have

undertaken to share best practice between companies such as hosting training for them or facilitating the sharing of expertise between companies in related sectors.

An example of a reporting template could be found here.

2.3 Ongoing engagement with Limited Partners

Fund managers should always consider contacting LPs to get guidance on G&BI management and have regular meetings or calls to discuss G&BI performance. Ongoing communication enables a constructive and trusting relationship to be built up between fund manager and LP that can be mutually beneficial. Many DFI LPs, including CDC, welcome being contacted for advice regarding G&BI matters (e.g. challenges faced by fund managers). DFIs can draw upon their experience and may be able to suggest solutions or possible ways forward — or put the fund in touch with others who might be able to help.

An increasing number of fund managers are seeking to incorporate G&BI into their mainstream LP communications, including Advisory Committee meetings, investor days, site visits and quarterly reports, as G&BI is increasingly seen as a material feature of the fund performance that should be reported together with other information. LPs typically welcomed this.

2.4 Public disclosure

Some LPs now actively encourage the funds in which they invest to report publicly on their approach to managing of G&BI issues in their portfolios in order to encourage public transparency in the investment sector. This is particularly the case in certain domiciles that have introduced recommendations or requirements for fuller disclosure, such as the UK Stewardship Code and the Code for Responsible Investment in Southern Africa (CRISA).

This information should be included either in annual reports already prepared by the fund and/or on the fund manager's website. Reports should focus on providing a balanced, objective and complete snapshot of the fund's investments. To contextualise the reporting, information on the fund's GBIMS should be included. Additionally, examples of how these G&BI values and approaches have contributed to improving performance or mitigating risk in portfolio companies should be given.