Private Equity Sustainable Investment Practice Guidelines

BACKGROUND

This document addresses the CalPERS Private Equity Program (PE) practices on Sustainable Investment and the monitoring of environmental, social and governance (ESG) issues across the portfolio. The practices described herein focus on long-term value creation and preservation. These practices are embedded in CalPERS' Investment Beliefs, the United Nations Principles for Responsible Investments (UNPRI) and the ESG Disclosure Framework.

A. CalPERS Investment Beliefs

Investment Belief 2: A long time investment horizon is a responsibility and an advantage.

Long time horizon requires that CalPERS:

- Consider the impact of its actions on future generations of members and taxpayers
- Encourage investee companies and external managers to consider the long-term impact of their actions
- Favor investment strategies that create long-term, sustainable value and recognize the critical importance of a strong and durable economy in the attainment of funding objectives

Investment Belief 4: Long-term value creation requires effective management of three forms of capital: financial, physical and human.

Investment Belief 7: CalPERS will take risk only where we have a strong belief we will be rewarded for it.

Investment Belief 9: Risk to CalPERS is multi-faceted and not fully captured through measures such as volatility or tracking error.

Sub-belief: As a long-term investor, CalPERS must consider risk factors, for example climate change and natural resource availability, which emerge slowly over long time periods, but could have a material impact on company or portfolio returns.

B. UNPRI Principles

As of 2013, CalPERS is a signatory to the UN Principles for Responsible Investments (UNPRI), which includes the principles below:

Principle 1: We will incorporate ESG issues into investment analysis and decision-making processes.

Principle 3: We will seek appropriate disclosure on ESG issues by the entities in which we invest.

C. Global Governance Principles

CalPERS believes that environmental, social and corporate governance issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, and asset classes through time.) - *Introduction - paragraph 4, page 6 (approved March 16, 2015)*

D. Private Equity Program

In March 2013, CalPERS endorsed the Environmental, Social, and Corporate Governance (ESG) Disclosure Framework for Private Equity including the following sections:

Section 1: During fund-raising, a GP should seek to disclose information sufficient to enable an LP that has expressed an interest in ESG management to:

1) Assess if the GP is aligned with the LP's ESG-related policy and investment beliefs

2) Assess the GP's policies, processes, and systems for identifying ESG-related value drivers and managing material ESG-related risks; and to identify possible areas for future development

3) Understand if and how the GP influences and supports its portfolio companies' management of ESG related risks and pursuit of ESG-related opportunities

4) Assess how the GP will help the LP to monitor and, where necessary, ensure that the GP is acting consistent with the agreed-upon ESG-related policies and practices as set forth at fund formation

5) Assess the GP's approach to managing and disclosing material incidents at the GP and portfolio companies

Section 2: During the life of a fund, a GP should seek to disclose information sufficient to enable an LP that has expressed an interest in ESG management to:

1) Establish if a GP is acting in a manner consistent with the GP's investment policies, processes, and agreed-upon fund terms regarding ESG management.

2) Understand positive and negative ESG-related developments that may impact portfolio companies in the fund.

3) Determine if responses to GP and portfolio company incidents and incident reporting are consistent with relevant investment terms, the fund's policies, and the LP-stated objectives regarding incident disclosure.

Private Equity Program Guidelines

Item 1: Private Equity Staff will consider ESG issues that may have a material effect on investments in the Private Equity portfolio. Considerations should be made in the context of fiduciary responsibility with the goal of achieving the highest risk-adjusted returns to the overall portfolio

Item 2: Private Equity Staff will be guided by the CalPERS' Investment Beliefs, the United Nations Principles for Responsible Investments (UNPRI), the ESG Disclosure Framework, and the CalPERS Global Governance Principles

ESG FACTORS

Private Equity currently utilizes the UNPRI ESG Factors and the MSCI Intangible Value Assessment Methodology Hierarchy (see Appendix A & B) as sources for identifying potential relevant ESG risks and opportunities. Staff recognizes there is not one single source that provides an exhaustive or conclusive list of ESG factors pertinent to all of Private Equity's diverse investments and that only a subset of ESG factors will be relevant to any particular investment. The ESG factors considered are expected to adapt over time as the industry evolves.

INVESTMENT PRACTICES

Private Equity's ESG practices are described below and are integrated into various investment activities. These practices are designed to evolve and adapt as CalPERS Sustainable Investment initiatives and industry best practices emerge and evolve over time.

A. Selection

Understanding environmental, social and governance issues is a regular part of Private Equity's risk assessment and due diligence on prospective investments, as well as prospective managers. Although the Private Equity Managers CalPERS invests with are primarily responsible for the management of ESG issues, knowing the General Partner's ESG policies and understanding their approach to ESG-related risk and opportunities will help Private Equity Staff assess alignment with CalPERS policies and make a more informed investment decision.

1. Screening General Partners for Fund Investments

Private Equity Staff uses a customized screening process for all Private Equity fund investment proposals. This process includes an item pertaining to the General Partner's written ESG policy. The overall investment proposal score will help Private Equity determine whether to move forward to diligence the investment opportunity. ESG is considered along other investment factors necessary to reach an informed decision. The ESG item within the screening process consistently formalizes ESG in the assessment process. A manager's ESG policy, or lack thereof, will not exclude a proposal from moving forward to the formal diligence process; rather, it will be taken into account in the context of evaluating all relevant investment parameters.

2. Manager Selection for Fund Investments

As part of the manager selection process, Private Equity Staff will inquire about issues related to the external manager's ESG policies and procedures.

Private Equity Staff will:

a) Request the firm's ESG policies

b) Inquire about the way General Partners identify, monitor, mitigate and resolve ESG issues

c) Understand how General Partners have previously identified and addressed meaningful ESG risks as well as opportunities in their portfolio

d) Consider the General Partner's approach to incorporating ESG factors into investment decision-making and ownership activities, and ask for examples on how they engage portfolio companies on ESG factors

e) Inquire about General Partner's procedure for identifying ESG related issues to investors

f) Request disclosure on any ongoing litigation related to ESG issues

Final Diligence Reviews on new investments will include an ESG section. Material ESG issues may be discussed at the Private Equity Investment Review Committee (IRC) before voting and final investment approval occurs. The discussion around ESG issues will depend on their relevance to a particular investment opportunity. At the conclusion of the selection process, CalPERS Private Equity Managing Investment Director, Investment Director, and Investment Manager will sign off on adherence to the above process before a new investment is closed.

3. Co-Investment and Direct Investment Due Diligence

In addition to the due diligence done for an initial fund investment, Private Equity staff will complete the following additional diligence for Co-investments and Direct Investments:

a) Confirm the General Partner's ESG policy applies to the Co-investment or Direct investment

b) Request disclosure on any ongoing ESG litigation related to ESG issues

c) Review available diligence materials on ESG risks and opportunities

d) Inquire about the way General Partners have gotten comfortable any material ESG risks identified

e) Include an ESG section (if applicable) in Final Diligence Reviews discussing relevant material ESG issues

f) Material ESG issues may be discussed at the Investment Review Committee (IRC) before voting and final investment approval occurs

B. Contracting

Private Equity seeks to promote greater alignment with its external managers by establishing, where possible, relevant and effective, the following items in contracts:

1) Managers have or will commit to have, an investment process which incorporates an assessment of relevant long-term Sustainable Investment or ESG factors;
2) Managers will incorporate relevant ESG factors and Sustainable Investment activities into reporting.

C. Monitoring and Management

Private Equity Staff will review ESG-related issues as part of investment management process in the following ways:

1) For the top 10 managers in the PE portfolio by value, staff will inquire at the annual LPAC meetings regarding the Firm's ESG-related issues, including:

    - Their ongoing process for identifying and acting on ESG-related opportunities and risks
    - New or ongoing litigation issues pertaining to ESG
    - Material ESG issues that may impact the value of the portfolio, including assessing climate change risk, for example

2) For all other managers, Private Equity Staff will document any ESG-related issues they become aware of in periodic meeting notes.

3) Private Equity Staff will review Private Equity Manager ESG reports and UNPRI Reporting on an annual basis.

ADAPTABILITY of the CALPERS PRIVATE EQUITY ESG GUIDELINES

The *CalPERS Private Equity ESG Guidelines* are designed to evolve and adapt as CalPERS' Sustainable Investment initiatives and industry best practices advance over time.

1) Private Equity Staff will keep the *CalPERS Private Equity ESG Guidelines* as a standing item for review at the bi-weekly CalPERS Private Equity Procedures meetings.

2) Private Equity Staff can recommend changes and in the document, which will be approved by the Senior Team before they are adopted into the *Private Equity ESG Guidelines*.

APPENDIX

Item A: Examples of ESG factors

Environmental	Social	Governance
Biodiversity	Customer satisfaction	Accounting standards
Climate change	Data protection and privacy	Anti-competitive behavior
Deforestation	Diversity and equal opportunities	Audit committee structure
Ecosystems services	Employee attraction and retention	Board composition
Energy efficiency	Employee engagement	Bribery and corruption
Hazardous materials	Government and community relations	Business ethics
Land degradation	Human capital management	Compliance
Resource depletion	Human rights	Executive remuneration
Water management	Indigenous rights	Lobbying
Water scarcity	Labor standards	Political contributions
	Labor-management relations	Risk management
	Marketing communications	Separation of chairman and CEO
	Product mis-selling	Stakeholder dialogue
	Product safety and liability	Succession planning
	Supply chain management	Whistleblower schemes

Source: Responsible investment in private equity- a guide for limited partners (2nd edition), PRI, p.24

Item B: MSCI ESG Research, IVA Model Hierarchy