

INTERNATIONAL JOURNAL FOR LEGAL RESEARCH AND ANALYSIS



Open Access, Refereed Journal Multi-Disciplinary
Peer Reviewed

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FROM CAPITAL TO COMPLIANCE: THE EXPANDING ROLE OF ESG IN PRIVATE EQUITY INVESTMENT STRATEGIES

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Introduction

Over the past two decades, there has been a balanced metamorphosis in the reporting practices embraced by the corporate sector worldwide. In addition to the long-established financial disclosures, there has been an enlarging focus on qualitative reporting, particularly concerning matters of governance, sustainability, and social responsibility, collectively known as Environmental¹, Social², and Governance³ disclosing.⁴

PE⁵, encompassing buyout and venture capital transactions, illustrate a vital segment of contemporary financial systems. While quite a few definitions of Private equity are available, the best way to characterize it would be as a medium-to long-term equity investment in companies that aren't listed on public exchanges.⁶ The scope of PE extends beyond venture capital and buyout deals to include investments in hedge funds, FoFs, PIPEs, distressed debt funds, and various other non-publicly traded securities.⁷

A unique market and a hybrid investment model that combines financial rewards with social and environmental goals have been created by shareholder activists and supporters of socially conscious investing. Nevertheless, since the central principles of capital accumulation remain predetermined, these actors often negotiate the tension between their activist intentions and the requisites of financial investment.⁸

¹ Maria Cristina Zaccone and Matteo Pedrini, ESG Factor Integration into Private Equity (2020) 12 Sustainability 5725

² Maria Cristina Zaccone and Matteo Pedrini, ESG Factor Integration into Private Equity (2020) 12 Sustainability 5725

³ Maria Cristina Zaccone and Matteo Pedrini, ESG Factor Integration into Private Equity (2020) 12 Sustainability 5725

⁴ A Singh, P Singh and S Shome, ESG–CFP Linkages: A Review of Its Antecedents and Scope for Future Research (2022) 15 Indian Journal of Corporate Governance 48.

⁵ Milena Prisco, The Impact of ESG Considerations on Private Equity and Venture Capital Transactions: The Western Scenario (2024) Vol. 25 Business Law International 21

⁶ Harry Cendrowski and Adam A Wadecki, Introduction to Private Equity (John Wiley & Sons 2012)

⁷ Harry Cendrowski and Adam A Wadecki, Introduction to Private Equity (John Wiley & Sons 2012)

⁸ L King and E Gish, Marketizing Social Change: Social Shareholder Activism and Responsible Investing (2015) 58 Sociological Perspectives 711

ESG⁹ factors have modified over the past few years from being only moral predilection to becoming critical elements of both business strategy and legal compliance. Private equity firms are currently under compulsion to incorporate ESG concepts into their ethical, open, and sustainable investment procedures due to regulatory requirements, investor demands, and stakeholder inspection.

The Darwinism of ESG from a voluntary, value-based framework to a legally obligatory compliance and strategic requirement in private equity is examined in this essay. It highlights how ESG will affect future investment behaviour by examining the legal and regulatory maturity as well as the practical integration of ESG in both Indian and global contexts.

Evolution of ESG in Private equity

PE firm's scope to integrate ESG considerations into the management of their portfolio companies has recently come under greater inspection. GPs¹⁰ in fundraising are not the only ones who are aware of this change; factors like possible cost savings, pressure from competitors, and changing regulations have all increased the emphasis on ESG considerations in investment committee discussions.¹¹

Investor's heightening understanding of how non-financial factors influence value creation, sustainable business performance, and overall social well-being has coincided with the increased emphasis on ESG factors. This increased understanding has been strengthened in recent years by numerous organizations and trade associations that have established best practices standards. A comprehensive framework for incorporating sustainability and ESG principles into investment analysis and ownership activities across many asset classes is provided by the UNPRI¹², which was created by a global coalition of investors.¹³

Working in alignment with the UNPRI, the PEGCC¹⁴ formulated its Guidelines for Responsible Investment, emphasizing environmental, health, safety, labour, governance, and

⁹ Maria Cristina Zaccone and Matteo Pedrini, ESG Factor Integration into Private Equity (2020) 12 Sustainability 5725

¹⁰ Bowen White, ESG in Private Equity: A Fast-Evolving Standard (INSEAD Business School) 3

¹¹ Bowen White, ESG in Private Equity: A Fast-Evolving Standard (INSEAD Business School) 3

¹² Bowen White, ESG in Private Equity: A Fast-Evolving Standard (INSEAD Business School) 3

¹³ Bowen White, ESG in Private Equity: A Fast-Evolving Standard (INSEAD Business School) 3

¹⁴ Bowen White, ESG in Private Equity: A Fast-Evolving Standard (INSEAD Business School) 3

social aspects within the specific framework of private equity investments.¹⁵

Together, the UNPRI and PEGCC guidelines, along with a firm's internal responsible investment policies, frequently serve as the cornerstone of a GP's ESG framework.

Global Legal and Regulatory Framework for ESG in Private Equity

ESG considerations are becoming more and more significant in M&A deals worldwide. Numerous factors put up to this tendency, such as a coherent change in investor sentiment, the banking industry's enlarging focus on sustainability ratings in addition to credit ratings, the implementation of required EU laws impacting the private equity industry, as well as the integration of ESG factors into the distribution of IPO profits.¹⁶

By setting a number of requirements and standards that have a substantial impact on the European capital market and, indirectly, have an influence on non-EU markets like those in the US and the UK, the European Commission has taken a prime role through its Action Plan on Sustainable Finance. Consequently, PE funds operating both within Europe and globally are now required to adhere to stringent sustainability norms and investor expectations to secure capital and raise funds in Western markets.¹⁷ Evidently, within the global private equity market, EU-based PE funds face a greater impact compared to their non-EU counterparts. Nonetheless, beyond mere regulatory requirements, the hold of ESG factors and associated risks is clearly observable in private equity transactions.¹⁸

Responsible investment practices are shaped by major international frameworks as the OECD¹⁹ Guidelines for Multinational Enterprises, the U.S.SEC's²⁰ advance ESG disclosure regulations, and the UN PRI. These frameworks uplift responsibility, openness, and long-term market growth. In order to satisfy investor expectations, reduce ESG-related risks, and preserve credibility in a financial environment that is becoming more and more focused on

¹⁵ Bowen White, *ESG in Private Equity: A Fast-Evolving Standard* (INSEAD Business School) 3

¹⁶ Milena Prisco, *The Impact of ESG Considerations on Private Equity and Venture Capital Transactions: The Western Scenario* (2024) Vol. 25 Business Law International 21

¹⁷ Milena Prisco, *The Impact of ESG Considerations on Private Equity and Venture Capital Transactions: The Western Scenario* (2024) Vol. 25 Business Law International 21

¹⁸ Milena Prisco, *The Impact of ESG Considerations on Private Equity and Venture Capital Transactions: The Western Scenario* (2024) Vol. 25 Business Law International 21

¹⁹ Douglas Cumming, Geoffrey Wood and Shaker Zahra (eds), *The Oxford Handbook of Private Equity* (Oxford University Press 2019)

²⁰ Douglas Cumming, Geoffrey Wood and Shaker Zahra (eds), *The Oxford Handbook of Private Equity* (Oxford University Press 2019)

sustainability, global private equity funds that invest across different jurisdictions must adhere to these requirements.²¹

Indian Regulatory and Policy Context

ESG investing in India is still in its early stages but is steadily gaining momentum. The heightening emphasis on climate-conscious investments and the encouragement of private sector participation in green energy have been by recent policy initiatives.²² Moreover, the Government of India's Economic Survey²³ 2020–21 highlighted the importance of aligning climate objectives with financial policies and outlined several measures aimed at promoting ESG investments across the country.²⁴

Indian companies are progressively incorporating ESG considerations into their business and investment decisions. For instance, AMC such as Axis Mutual Fund, ICICI Prudential, and Aditya Birla Sun Life have initiated ESG-focused schemes and are growingly adhering to ESG norms in their investment policy.

Major insights on the ESG performance of 50 publicly traded Indian firms were established (NSE 2020)²⁵. In contrast to other ESG dimensions, the study found that corporations typically perform better in policy-related disclosures. Social considerations were evaluated as the least important of these, and governance was found to be the best performing aspect. Moreover, the leading three companies belonged to the automobile, chemicals, and consumer goods sectors, whereas the metals and mining industry recorded the weakest ESG performance.²⁶

The government has come up several policy and regulatory measures to promote sustainable investment practices. The MCA has played a significant role in advancing responsible investment in India by periodically issuing policies and guidelines encouraging corporations to adopt the Principles of Responsible Investment. Complementing these efforts, the SEBI, the

²¹ Douglas Cumming, Geoffrey Wood and Shaker Zahra (eds), *The Oxford Handbook of Private Equity* (Oxford University Press 2019)

²² Gopal K Sarangi, *Resurgence of ESG Investments in India: Toward a Sustainable Economy* (ADBI Working Paper No 1284, Asian Development Bank Institute, Tokyo, 2021)

²³ Economic survey by Government of India, 2021

²⁴ Gopal K Sarangi, *Resurgence of ESG Investments in India: Toward a Sustainable Economy* (ADBI Working Paper No 1284, Asian Development Bank Institute, Tokyo, 2021)

²⁵ National Stock Exchange (NSE). 2020. *ESG Analysis on 50 Listed Companies in India*. Mumbai, India

²⁶ Gopal K Sarangi, *Resurgence of ESG Investments in India: Toward a Sustainable Economy* (ADBI Working Paper No 1284, Asian Development Bank Institute, Tokyo, 2021)

capital market regulator, has framed regulations addressing ESG-related investments. Both the MCA and SEBI are collectively working to execute ESG-focused guidelines and regulatory frameworks. Additionally, the government established the IIC, an industry body aimed at promoting impact investing in India and representing the interests of impact investors nationwide.²⁷

One of the recent efforts in this regard was the introduction of the “Voluntary Guidelines on Corporate Social Responsibility” by the MCA in 2009, aimed at embedding sustainability principles into business operations and decision-making processes. This was followed by the introduction of the new CSR Rules, 2014, under the Companies Act, 2013, which underscored the importance of ESG-focused norms and the integration of ESG strategies into corporate practices. The rules made it mandatory for companies to allocate at least 2% of their profits toward activities benefiting socially relevant sectors. In addition to these measures, the SEBI, as the capital market regulator, has periodically issued several circulars addressing different aspects of sustainable investing and outlining the reporting framework for such investments in the country.²⁸

In addition to RBI's guidance and government led initiatives to promote green and responsible finance, SEBI's initiatives, such as the BRSR, the ERP framework (2023–24), and ESG norms under the AIF Regulations²⁹, have shaped India's sustainable finance landscape.³⁰

ESG Integration in Private Equity Investment Cycle

In the PE investment cycle, ESG integration has evolved from a morally optional decision to a crucial part of risk and strategy management procedures. PE businesses are becoming more aware of the important effects that ESG considerations have on long-term financial performance and wealth generation.³¹ ESG due diligence is carried out to find possible hazards, legal obligations, and chances for long-term value growth at the pre-investment phase of the

²⁷ Gopal K Sarangi, *Resurgence of ESG Investments in India: Toward a Sustainable Economy* (ADBI Working Paper No 1284, Asian Development Bank Institute, Tokyo, 2021)

²⁸ Gopal K Sarangi, *Resurgence of ESG Investments in India: Toward a Sustainable Economy* (ADBI Working Paper No 1284, Asian Development Bank Institute, Tokyo, 2021)

²⁹ Securities and Exchange Board of India (Alternative Investment Funds) Regulations, 2012

³⁰ Securities and Exchange Board of India, *Business Responsibility and Sustainability Reporting (BRSR) Framework* (SEBI, 2021); SEBI, *Framework for ESG Rating Providers in Securities Market* (2023); Reserve Bank of India, *Discussion Paper on Climate Risk and Sustainable Finance* (RBI, 2022)

³¹ UN Principles for Responsible Investment, *ESG Integration in Private Equity: A Guide for General Partners* (UNPRI, 2014); Securities and Exchange Board of India, *Framework for ESG Rating Providers in Securities Market* (2023)

integration process.³²

PE managers actively work with portfolio companies during the ownership phase to enhance social responsibility frameworks, implement sustainability programs, and fortify governance structures, all while bringing them into line with international best practices. This improves competitiveness and resilience while reducing operational and reputational concerns.³³

An emerging market preference for sustainable businesses is reflected in the fact that companies with strong ESG credentials are frequently valued higher and draw ethical investors at the exit stage. Accountability and transparency are strengthened in the private equity ecosystem by the UNPRI and SEBI's regulatory frameworks in India, which further assist investors in integrating ESG issues throughout the investment lifecycle.³⁴

Challenges and Legal issues

The effective assumption of ESG principles in PE investment in India is hampered by a number of obstacles and legal concerns. The lack of clear ESG reporting and disclosure guidelines is one of the main issues, leading to uneven and fragmented data across industries. Comprehensive ESG incorporation throughout the PE ecosystem is limited because many unlisted portfolio companies and smaller businesses are still outside the scope of the BRSR Framework, which SEBI adopted to improve transparency. The lack of a legal requirement for private equity funds to incorporate ESG considerations into their investment procedures is another major issue. Adoption levels vary since current practices mostly rely on investor-driven regulations and voluntary disclosures rather than explicit regulatory requirements.³⁵

Credibility issues are also brought up by inconsistent ESG ratings and the possibility of greenwashing. By strengthening accountability and standardizing assessment procedures, the most recent SEBI Framework for ERPs 2023 aims to address these problems. Nonetheless, the

³² UN Principles for Responsible Investment, ESG Integration in Private Equity: A Guide for General Partners (UNPRI, 2014); Securities and Exchange Board of India, Framework for ESG Rating Providers in Securities Market (2023)

³³ UN Principles for Responsible Investment, ESG Integration in Private Equity: A Guide for General Partners (UNPRI, 2014); Securities and Exchange Board of India, Framework for ESG Rating Providers in Securities Market (2023)

³⁴ UN Principles for Responsible Investment, ESG Integration in Private Equity: A Guide for General Partners (UNPRI, 2014); Securities and Exchange Board of India, Framework for ESG Rating Providers in Securities Market (2023)

³⁵ Securities and Exchange Board of India, Business Responsibility and Sustainability Reporting (BRSR) Framework (SEBI, 2021)

implementation of ESG-related responsibilities is still in its infancy. Additionally, there is regulatory overlap across agencies like the MCA, SEBI, and RBI, which lift questions about compliance and reporting essentials. The MCA's National Guidelines on Responsible Corporate Conduct (2019) encourage ethical corporate practices, although their voluntary nature limits its enforceability.³⁶

To overcome these problems and ensure that ESG integration in private equity becomes a significant component of responsible investing rather than only an ideal, India needs well-built regulatory enforcement, standardized ESG metrics, and transparent legal frameworks.³⁷

Conclusion

The evolution of ESG from a voluntary, value-driven norms to an enforced compliance necessity represents a paradigm shift in India's private equity industry. Risk management, valuation, and long-term investment now rely on ESG integration. performance as investors, regulators, and stakeholders give sustainability more weight. The Indian regulatory ecosystem, which is supervised by SEBI, MCA, and RBI, has made remarkable progress in promoting responsible investment with instruments like the BRSR framework, ERP framework, and NGRBC. However, there are still concerns with inconsistent disclosures, a insufficiency of clear ESG standards, a lack of enforcement authority, and the potential for "greenwashing" or shaky compliance.

As a result, PE funds must amalgamate ESG principles into every facet of the investment cycle, from exit plans to due diligence and portfolio management, rather than just following rules. To attain this, a culture carry toward sustainable investing principles is just as necessary as more robust legal requirements and efficient policy coordination. As India follows with international ESG norms such as the UN Principles for Responsible Investment, the successful mainstreaming of ESG in PE depends on transparency, accountability, and measurable effects. Ultimately, rather from being merely an ethical objective, ESG compliance is a calculated necessity that influence the direction of capital and corporate governance in India.

³⁶ Securities and Exchange Board of India, Framework for ESG Rating Providers in Securities Market (SEBI, 2023)

³⁷ Ministry of Corporate Affairs, National Guidelines on Responsible Business Conduct (MCA, 2019)