Principles for Responsible Investment

STARTING UP

RESPONSIBLE INVESTMENT IN VENTURE CAPITAL

UN environment programme finance initiative

United Nations Global Compact

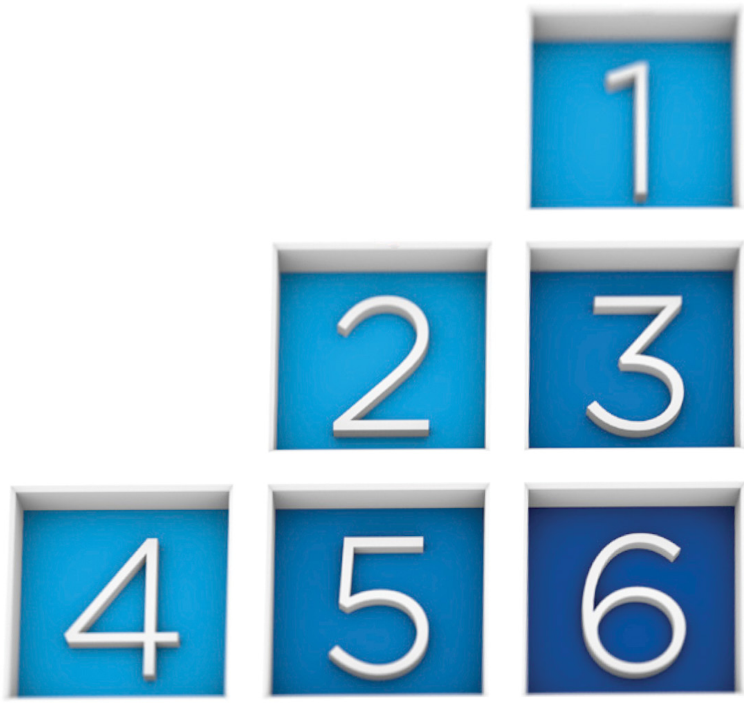
An investor initiative in partnership with UNEP Finance Initiative and UN Global Compact

THE SIX PRINCIPLES

PREAMBLE TO THE PRINCIPLES

As institutional investors, we have a duty to act in the best long-term interests of our beneficiaries. In this fiduciary role, we believe that environmental, social, and governance (ESG) issues can affect the performance of investment portfolios (to varying degrees across companies, sectors, regions, asset classes and through time). We also recognise that applying these Principles may better align investors with broader objectives of society. Therefore, where consistent with our fiduciary responsibilities, we commit to the following:

1. We will incorporate ESG issues into investment analysis and decision-making processes.
2. We will be active owners and incorporate ESG issues into our ownership policies and practices.
3. We will seek appropriate disclosure on ESG issues by the entities in which we invest.
4. We will promote acceptance and implementation of the Principles within the investment industry.
5. We will work together to enhance our effectiveness in implementing the Principles.
6. We will each report on our activities and progress towards implementing the Principles.



PRI's MISSION

We believe that an economically efficient, sustainable global financial system is a necessity for long-term value creation. Such a system will reward long-term, responsible investment and benefit the environment and society as a whole.

The PRI will work to achieve this sustainable global financial system by encouraging adoption of the Principles and collaboration on their implementation; by fostering good governance, integrity and accountability; and by addressing obstacles to a sustainable financial system that lie within market practices, structures and regulation.

CONTENTS

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EXECUTIVE SUMMARY

Venture capital is a vital part of the financial ecosystem and a significant engine for job creation and innovation. It is hugely influential in how we will all live in the future.

It plays a critical first role in the investment chain by:

- underwriting the next generation of business leaders and leading companies worldwide;
- funding innovation to advance technological solutions that may help solve some of society's greatest issues.[1]

However, venture capital investments have the potential to be incredibly disruptive to the broader economy and society, carrying significant positive or negative consequences that need to be assessed and/or mitigated.

When successful, early-stage companies are sold to strategic corporate buyers that may be publicly listed; private equity firms; or directly to the public market through initial public offerings (IPOs) and other mechanisms. How these are managed at an early stage impacts buyers and other investors further up the investment chain.

Venture capital general partners (GPs) have the opportunity to help establish positive culture, values and behaviours before they become ingrained and difficult to change as those companies scale.[2]

Unfortunately, with ESG incorporation practices only just starting to develop, this opportunity is often not seized upon, despite many venture-backed companies – and the sectors and technologies they are exposed to – posing risks, such as:

- social risks, including privacy rights and other human rights risks, bias and discrimination in algorithms, and risks relating to income inequality, for example, in the move to automation;
- governance concerns and failures, including the use of dual share-class structures; and
- climate-related risks, such as the energy consumption of blockchain technologies and cryptocurrencies.

The venture capital industry must improve its practices on diversity, equity and inclusion, both at the GP level and at investee companies. The industry has a pronounced lack of diversity, and – particularly in Silicon Valley – a poor track record of sexual harassment incidents.[3] Although many firms are actively taking steps to address these issues, and industry-wide initiatives have also emerged, more progress is needed.

CURRENT ESG APPROACHES

Overall, there is a lack of formal, standardised ESG incorporation across the venture capital industry, although interest is growing and collaborative work between venture capital firms is underway. Senior leaders of venture capital firms often drive this, and ESG incorporation could be crucial for firms to differentiate themselves in an increasingly competitive market. A growing battle for the best talent in early-stage companies may also lead the founder community to increasingly align their companies' values with those of their employees. Increasing regulation is also seen as a likely future driver of ESG uptake.

Momentum and practice are stronger in Europe – in the US, ESG incorporation is often still seen as a box-ticking exercise and scepticism about its value remains.

Our interviews highlighted that very few venture capital firms have dedicated ESG professionals providing in-house support. Venture capital firms are often small and have limited resources to dedicate to ESG practices. Too often, ESG oversight responsibility lies with investor relations personnel that have no role in investment decision-making or junior members of investment teams, which leads to little real action.

Nonetheless, there are examples of successful ESG incorporation practices that make sense for the asset class. For example, the use of tailored exclusion policies, specific ESG clauses in deal documentation, and post-investment surveys that monitor the risk exposures of early-stage companies as they grow.

1 For example, BioNTech, which developed a Covid-19 vaccine in collaboration with Pfizer, is backed by venture capital investors – for more detail, see Reuters (2021) Early backers of vaccine maker BioNTech in US$719 million payday.

2 Tech Crunch (2019) Why Venture Capital Funds Need Culture Experts.

3 See, for example, Institutional Investor (2018) Venture Capital Has a 'MeToo' Problem. Have Investors Been Ignoring It? and Chang (2018) Brotopia: Breaking Up the Boys' Club of Silicon Valley.

CHALLENGES

Significant barriers to mainstream adoption remain:

- There is a perception among many venture capital GPs and early-stage companies that ESG issues are not material to the asset class – due to their early-stage nature, the high failure rate of investments and a growth-at-all-costs approach that side-lines these issues.
- GPs' influence on investees can be limited, particularly if they take a founder-friendly approach to winning investments.
- LPs have little influence over successful venture capital firms, with asset owners that conduct ESG due diligence sometimes considered difficult. Successful venture capital firms compete for the best founders and entrepreneurs, not LPs.
- Few tailored resources are available to help investment managers better understand how to set relevant ESG metrics and targets in venture capital.

GPs and LPs need to be pragmatic with their ESG expectations, tailoring them appropriately to the company's growth stage while recognising the opportunity to help instil good practice. They also need more opportunities to collaborate with peers and raise standards within the asset class.

NEXT STEPS

For responsible investment to flourish in the industry, understanding and knowledge about its application and benefits must improve at all stages of the venture capital funding spectrum and investment process.

The PRI will consider taking a number of steps to contribute to this effort, including:

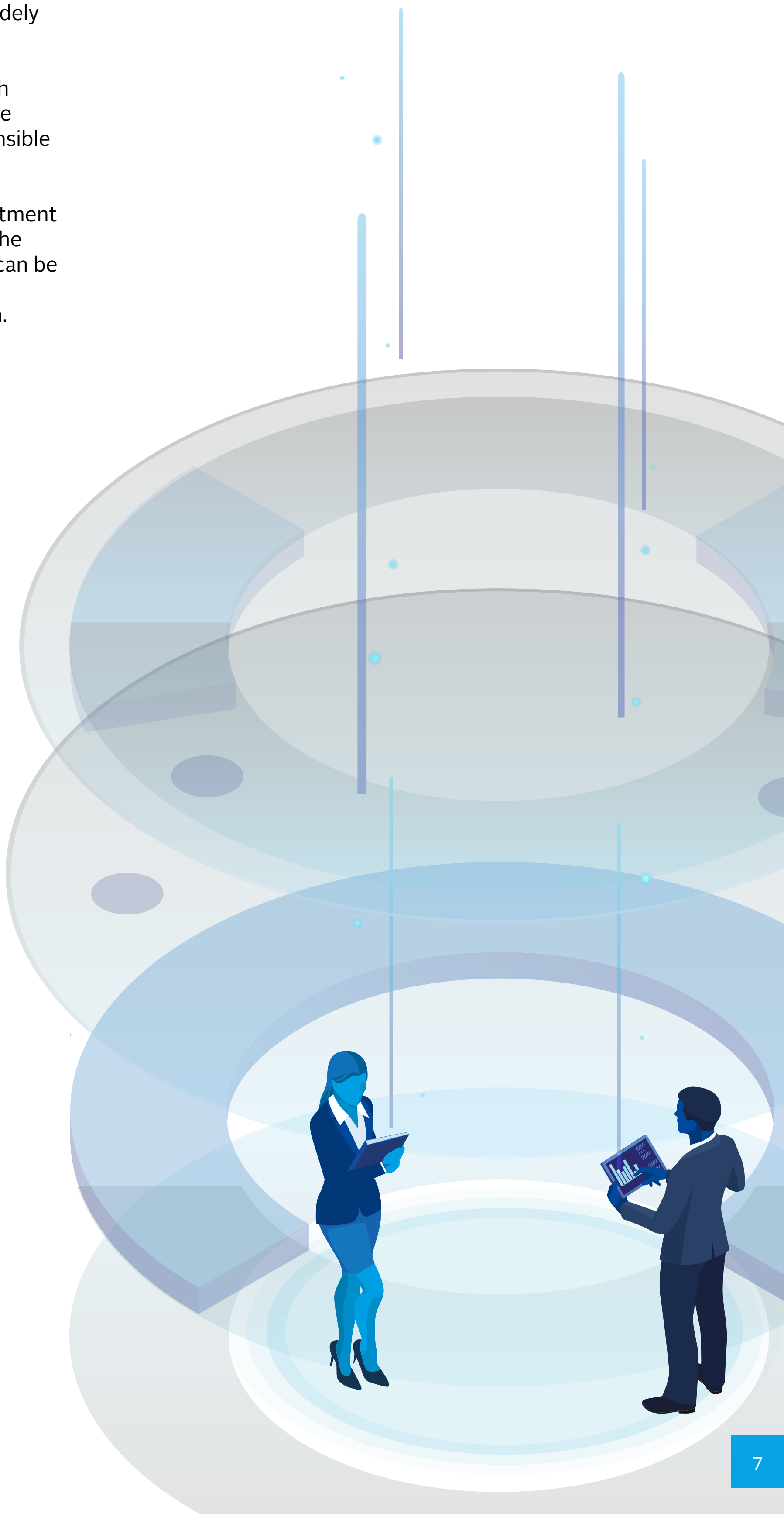
- Broadening signatory understanding
- Sharing best practice
- Convening asset owners and venture capital firms
- Driving standardisation

ABOUT THIS PAPER

This report explores the nascent development of ESG incorporation in the venture capital industry. It highlights current approaches and examples of emerging good practice; alongside the substantial barriers that need to be addressed for responsible investment to be more widely adopted across the venture capital industry.

It expands the PRI's private markets resources, which have primarily been focused on other areas of private equity, infrastructure and private debt, where responsible investment practice is more advanced.

The PRI interviewed a range of venture capital investment managers, asset owners, and other stakeholders in the research for this paper. We welcome feedback that can be used to take our venture capital work forward – contact vc@unpri.org to contribute to the discussion.



MARKET OVERVIEW

KEY TAKEAWAYS

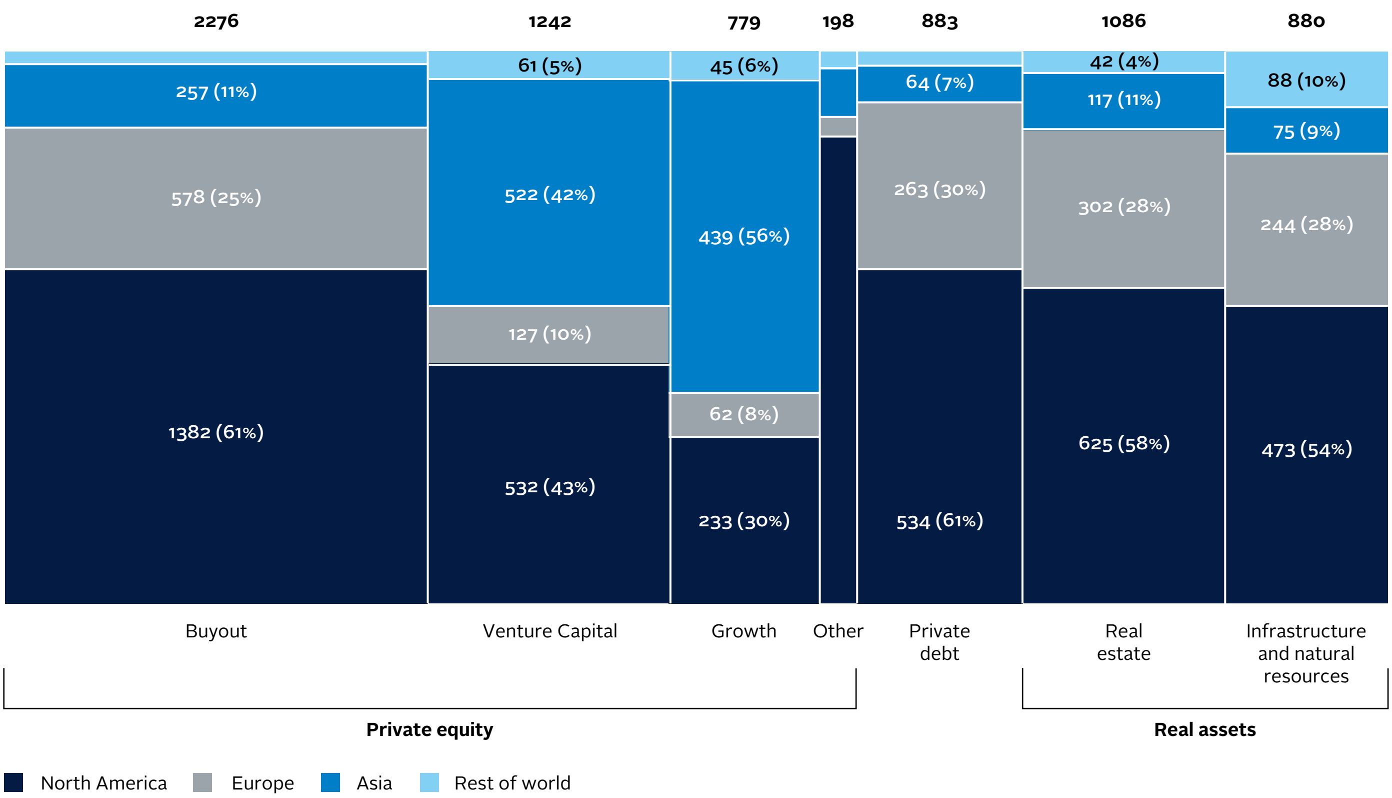
- Venture capital investments have the potential to be incredibly disruptive to the broader economy and society and can be exposed to a range of ESG risks with significant consequences, including privacy violations; human rights abuses; poor governance and climate-related risks.
- Developing responsible investment practices can ensure that these are assessed and/or mitigated, and that venture capital-backed companies are managed responsibly from the outset.
- The distinctions between venture capital and other areas of private equity are fundamental to understanding why ESG incorporation can be challenging for investment managers – something that asset owners do not always differentiate for.
- Several initiatives are developing to help market participants understand:
  - what responsible investment means for venture capital, and
  - how to incorporate ESG factors systematically.

Venture capital is a vital part of the financial ecosystem and a significant engine for job creation and innovation. It plays a critical first role in the investment chain by:

- underwriting the next generation of business leaders and leading companies worldwide;
- funding innovation to advance technological solutions that may help solve some of society's greatest issues.[4]

Global venture capital AUM reached US$1.24trn in the first half of 2020, according to the McKinsey report A year of disruption in private markets, invested mainly in the US (43%) and Asia (42%) (see Figure 1). The total value of investments made during 2020 was approximately US$300bn, distributed among around 22,000 companies, predominantly in the technology sector.[5] This is set to be much higher in the next few years.[6]

Figure 1: Private market assets under management (US$ billions). Source: McKinsey & Company.



4 For example, BioNTech, which developed a Covid-19 vaccine in collaboration with Pfizer, is backed by venture capital investors – for more detail, see Reuters (2021) Early backers of vaccine maker BioNTech in US$719 million payday.

5 Crunchbase News (2021) Global VC Report 2020: Funding And Exits Blow Past 2019 Despite Pandemic Headwinds

6 Crunchbase News (2021) Global Venture Funding Hits All-Time High In First Half Of 2021, With $288B Invested

Venture capital financing must be provided responsibly, however, as these investments have the potential to be incredibly disruptive to the broader economy and society – indeed, disruption has been a stated objective of the industry. For example, until 2014, Facebook's motto was: "Move fast and break things."

Consequently, the asset class can have significant positive or negative consequences that need to be assessed and/or mitigated (See Assessing the risks inherent in venture-backed companies). Developing responsible investment practices can help ensure that venture capital-backed companies are more sustainable and managed responsibly from the outset.

When successful – up to 75% of early-stage companies fail[7] – they are sold to strategic corporate buyers that may be publicly listed; private equity firms; or directly to the public market through initial public offerings (IPOs) and other mechanisms.

In the US, venture capital-backed companies make up nearly 76% of the total public-market capitalisation of companies started since 1995.[8] How they are managed at an early stage impacts these buyers and other investors further up the investment chain.

Venture capital general partners (GPs) can help establish a positive culture, values and behaviours before they become ingrained and difficult to change as those early-stage companies scale.[9] But, unfortunately, this opportunity is often not seized upon.

Many venture capital GPs either do not have formalised ESG incorporation processes in place or are still trying to understand what is required to implement them. In addition, asset owners generally allocate only a small proportion of their portfolios to venture capital. Therefore, they have historically focused on ESG practices in other asset classes and do not always tailor their approach appropriately to venture capital. For example, when undertaking due diligence on, or engaging with, GPs (see How venture capital differs from other areas of private equity).

7 Wall Street Journal (2012) The Venture Capital Secret: 3 Out of 4 Start-Ups Fail
8 The Economist (2021) The Bright New Age of Venture Capital
9 Tech Crunch (2019) Why Venture Capital Funds Need Culture Experts

HOW VENTURE CAPITAL DIFFERS FROM OTHER AREAS OF PRIVATE EQUITY

Although the venture capital investment process (from deal sourcing to exit) is similar to that of growth equity or buyout transactions, it differs from these private equity sub-asset classes in several ways, as highlighted in Table 1.

Additionally, in venture capital, the power dynamics between GPs and LPs are often skewed towards GPs, while founders of investee companies ultimately wield the most influence.

These distinctions are fundamental to understanding why ESG incorporation can be challenging for venture capital managers – something that asset owners do not always recognise – and will be explored later in the paper.

Table 1: Venture capital and buyout – main differences.

Characteristic	Venture capital	Buyout
Fund size	<US$50m to US$1bn+	<US$500m to US$25bn+
Number of investments per fund	10 – 40+	10 – 20
Equity stake and degree of influence	Varies, generally 1% – 20%. Can often be diluted due to involvement of multiple GPs during various funding rounds. Often with board seats	Often control investments >50% equity ownership
Internal resources	Depends on fund size, but leaner than buyout firms	Depends on fund size
Size of investee company	Small	Mid cap to large cap
Due diligence level	Low to moderate	High
Financial leverage	Generally, little	High[10]
Typical target sectors	Technology, biotech	Technology, industrials, healthcare, consumer, financial services, energy
Investee company business model	Disruptive, rapidly evolving product and/or team, often pre-revenue or pre-profit	Cashflow positive, mature businesses
Deal sourcing	Organic networks of venture capital managers	Investment banks, other buyout firms, manager networks

10 In 2020 almost 80% of investments were leveraged at or over 6x debt/EBITDA – see Bain and Company (2021) The Private Equity Market in 2020: Escape from the Abyss.

ASSESSING THE RISKS INHERENT IN VENTURE-BACKED COMPANIES

Below we outline some of the risks inherent in venture-backed early-stage companies, particularly as they scale, as well as highlighting some of the areas where venture capital could shape positive sustainability outcomes.[11]

Social issues

The sectors and disruptive technologies frequently targeted by venture capitalists can be exposed to a range of social risks, including:

- Privacy violations (e.g. in specific uses of facial recognition technology, data collection and marketing by social media companies)
- Bias and discrimination (e.g. in the use of algorithms)
- Income inequality and wage polarisation (e.g. through artificial intelligence and the move to automation, and the use of business models that do not recognise workers as employees[12])

Investors are not paying enough attention to these risks, nor are they integrating human rights considerations into their investments.

A recent report by Amnesty International, Risky Business: How Leading Venture Capital Firms Ignore Human Rights When Investing in Technology, found that the world's ten largest venture capital firms are all failing on their human rights due diligence responsibilities. A lack of human rights due diligence could have significant consequences – venture capital GPs may be investing in companies whose products or services have ongoing human rights risks. They may also fund new and frontier technologies or business models that could have significant negative outcomes for human rights in the future.

Many venture capital success stories – companies that are now household names, such as Facebook and Uber – also remain a cause for concern. This is likely to continue as populations become increasingly exposed to venture capital-backed companies.

VENTURE CAPITAL IN EMERGING MARKETS – POTENTIAL TO SHAPE POSITIVE SUSTAINABILITY OUTCOMES

In an emerging markets context, venture capital can be particularly impactful, financing businesses that meet the needs of local communities and contributing to closing the substantial funding gap required to meet the Sustainable Development Goals by 2030. India is one market that has already attracted significant venture capital backing, as evidenced by the prevalence of unicorns – for example, Unacademy and Byju's seek to democratise access to high-quality education, while others, such as paytm, aim to help improve financial inclusion. Going forward, the PRI will focus on increasing support for responsible investment in emerging markets, as outlined in the PRI's Strategic Plan 2021 - 24.

DIVERSITY, EQUITY AND INCLUSION AND THE VENTURE CAPITAL INDUSTRY

DEI is an area that cuts across the investment chain, impacting GPs, LPs and early-stage companies. Venture capital and the broader technology industry it invests in, have faced increasing scrutiny, particularly in the US, for lacking diversity. Often dubbed bro culture – these damaging behaviours have been allowed to go unchecked.[13]

In the US, women comprised just 16% of senior-level venture capital investment professionals, and black employees made up only 4% of the entire workforce in 2021.[14] In addition, as many as 40% of venture capital investment decision makers were educated at just two colleges, Stanford and Harvard.[15]

As most investments are sourced through venture capital GPs' business networks, such a lack of diversity has significant consequences. It:

- **perpetuates the diversity problem,** with vanishingly few female and minority founders receiving funding;
- **increases the risk of missing significant investment opportunities;** and
- **increases the risk of poor decision making** through groupthink.

Some venture capital GPs recognise these issues and have been founded expressly to reduce racial and gender inequality through their investments. For example, US firm Harlem Capital aims to invest in 1,000 diverse entrepreneurs over the next 20 years, while Impact X in the UK invests in underrepresented entrepreneurs across Europe. There are also initiatives developing to make the venture capital industry more inclusive (see Emerging initiatives and guidance).

11 As outlined in the PRI report Investing with SDG outcomes: A five-part framework for investors, all investor actions shape positive and negative outcomes in the world. Investors wanting to support the SDGs must understand the outcomes from their investments and related activities and seek to shape those in line with sustainability goals.

12 See The Guardian (2016) Uber loses right to classify UK drivers as self-employed and PRI (2019) Uber IPO: What are the ESG risks and opportunities?

13 See, for example, Institutional Investor (2018) Venture Capital Has a 'MeToo' Problem. Have Investors Been Ignoring It? and Chang (2018) Brotopia: Breaking Up the Boys' Club of Silicon Valley.

14 Deloitte, National Venture Capital Association, Venture Forward (2021) VC Human Capital Survey

15 Forbes (2021) Check Your Stats: The Lack Of Diversity In Venture Capital Is Worse Than It Looks

Governance issues

There is not enough focus on good governance across the asset class, evidenced by several high-profile governance failures at venture-backed companies, including Uber, WeWork, Deliveroo, and Theranos. Poor governance also increases the chances that social and environmental risks will be poorly managed.

This lack of focus is often by design. Many venture capital GPs feel that being founder-friendly – investing with few governance expectations attached – creates an advantage for winning deals in an extremely competitive environment. Where such investments are made, entrepreneurs are free to run and grow their businesses with very little influence from venture capital GPs.

There is generally a lack of independent directors on boards, with research indicating that early-stage companies have just 0.8 independent board members, on average, across the various stages of their lifecycle.

At a more systemic level, technology governance failure is a significant medium-term risk, according to 50% of respondents cited in the WEF Global Risks Report 2021, and one that the venture capital industry is particularly exposed to, given the prevalence of investments made in technology – particularly frontier technologies.

The OECD defines technology governance as exercising political, economic and administrative authority in the development, diffusion and operation of technology in societies, through the activities of governments, companies, civil society organisations and communities of practice.

According to the WEF, the risks associated with poor technology governance include issues of privacy, liability, cross-border regulatory discrepancies and the potential for misuse by bad actors.[16]

Other governance issues are also prevalent in, but not exclusive to, the technology industry. For example, the dual share-class structure found in some venture-backed early-stage companies, which grants founders superior voting rights over other investors, creates a discrepancy between economic ownership and control. Research published in the Virginia Law Review suggests that companies with such structures face more governance challenges than those without.

Environmental issues

Research indicates that the technology sector is responsible for around 1.8% – 2.8% of global greenhouse gas emissions but it could be as high as 3.9%.[17] Reflecting this, our discussions indicate that many venture capital GPs (especially in the US) do not perceive the companies and sectors they invest in to be high greenhouse gas emitters; consequently, they often do not believe environmental risks and opportunities are relevant to their investment strategies.

However, climate-related risk can be material. For example, cryptocurrencies and the blockchain technology that underpins them – an area that has attracted significant venture capital investment – consumes as much energy as some medium-sized European countries, albeit some of it comes from renewable sources.[18]

Furthermore, technology companies are likely to face greater scrutiny[19] as investors increasingly realise that the data, products and services they provide are not environmentally costless[20] and focus more on their scope 3 emissions. Importantly, venture capital GPs must do more to consider the environmental outcomes their start-up companies might shape once they achieve scale, by assessing their business models and associated risks from the outset.

CLIMATE TECH – A GROWING INVESTMENT THEME

Despite the prevailing attitude towards environmental issues associated with many venture capital investments, some investors recognise that the asset class could significantly contribute to their resolution. From lowering the carbon footprint of buildings to precision farming or autonomous maintenance technologies, climate tech start-ups provide a growing investment theme.[21] In the first half of 2021, venture capital funds invested US$16bn across 250 climate-focused companies, almost as much as in all of 2020.[22] Venture capital firms such as Union Square Ventures in the US, and Pale Blue Dot in Europe, have successfully raised funds in this area.

16 WEF (2021) Global Technology Governance Report 2021: Harnessing Fourth Industrial Revolution Technologies in a COVID-19 World

17 Small World Consulting Ltd., Lancaster University (2020) The climate impact of ICT: A review of estimates, trends and regulations

18 Financial Times (2021) Bitcoin's growing energy problem: 'It's a dirty currency'

19 Responsible Investor (2021) ESG funds could be left holding major emitters as Big Tech faces up to Scope 3, warns investor

20 Aviva (2021) Investors should confront the dark side of tech

21 The Economist (2021) Billions are pouring into the business of decarbonisation

22 Bloomberg (2021) Climate startups are booming as VC throws money at climate tech

EMERGING INITIATIVES AND GUIDANCE

Several initiatives are developing to help market participants better understand what responsible investment means in a venture capital context, and how to more systematically incorporate ESG factors in investment processes, some of which we detail below.

GENERAL GUIDANCE

- Responsible venture capital, a report by CDC Group and Dutch development bank FMO, provides a framework for venture capital investors to consider and manage the ESG risks and opportunities most applicable to them.
- Harvard Kennedy School published Responsible Investing in Tech and Venture Capital to highlight several challenges and potential solutions for managing societal impacts of venture capital firms and portfolio companies.
- Growing the Seeds of ESG: Venture Capital, Start-Ups and the Need for Sustainability, published by German venture capital manager KfW Capital and Boston Consulting Group, outlines an approach the venture capital industry can take to assess and benchmark their ESG integration efforts.

DIVERSITY, EQUITY AND INCLUSION

- Diversity VC and Level 20 support a diverse network of venture capital professionals and provide recruitment guidance to venture capital firms.
- The National Venture Capital Association (NVCA) supports Venture Forward, a non-profit organisation promoting a strong and inclusive community within the industry.
- Some high-profile venture capital firms have also set up investment vehicles to improve diversity in the industry, known as diverse founder funds.

HUMAN RIGHTS

- The PRI's report, How and Why Investors Should Act on Human Rights, sets out the three-part responsibility that all investors, including venture capital investors, have to respect human rights in their investment activities, as defined in the UN Guiding Principles on Business and Human Rights (UNGPs) and reflected in the OECD's Guidelines for Multinational Enterprises.
- Amnesty International's Silicon Valley Initiative focuses on the human rights risks of surveillance technologies. This is particularly relevant as nearly US$10bn was invested by venture capital into privacy and security companies in 2019.[23]
- The UN's Office of the High Commissioner on Human Rights provides guidance and resources for implementing the UNGPs in the technology space through its B-Tech Project.

CLIMATE CHANGE

- Leaders for Climate Action has created an innovative sustainability clause for venture capital term sheets and shareholder agreements that bind companies to climate action.
- The PRI has produced guidance on TCFD reporting for private equity investment managers that could also apply to late-stage venture capital investors.
- The UN-supported Crypto Climate Accord has been established to decarbonise the cryptocurrency and blockchain industry. Venture capital GPs could use or adapt the initiative's resources, which include guidance on ESG reporting and good practices related to energy and carbon accounting and procurement, as part of their investment due diligence or to improve practices at their early-stage companies.

ESG INCORPORATION

- VentureESG, founded by GPs from GMG Ventures and Houghton Street Ventures alongside a Cambridge University academic, is a community of investment managers working toward defining the ESG issues that are material and relevant to venture capital and integrating them by using questionnaires, engagement with founders, and setting KPIs.
- ESG_VC has developed a 48-question standardised ESG portfolio company questionnaire. The BVCA hopes to use the survey responses to produce benchmarks and analyses that can establish what leading practice looks like in each survey area for businesses of different sizes.
- ROSE is a framework tailored to individual portfolio companies, focusing on measuring their impact on sustainability outcomes.
- Venture capital GPs may find some of the guidance contained in PRI (2014) Integrating ESG in Private Equity: A Guide for General Partners applicable to their investment strategies and businesses.

23 Crunchbase (2020) Almost $10B Invested In Privacy And Security Companies In 2019

CURRENT ESG APPROACHES

KEY TAKEAWAYS

- Senior leaders of venture capital firms drive interest in ESG incorporation, while changing preferences among early-stage company founders and regulation are anticipated to do so in future.
- ESG incorporation practices are not standardised across the industry and are generally less sophisticated than in growth equity or buyout firms.
- Few GPs have dedicated ESG professionals – teams are generally small and have limited resources. As a result, oversight responsibility often lies with personnel that do not make investment decisions, leading to little real action.
- Greater industry education is needed – interviewees highlighted widespread misunderstanding around basic terminology and an interest in learning more about ESG incorporation, target setting and using the SDGs and other frameworks to inform their investments.
- Nonetheless, some venture capital GPs are beginning to successfully incorporate ESG factors into their investments in a manner that makes sense for the asset class.

This section highlights current ESG approaches among venture capital investors, based on:

- a survey of venture capital firms, including PRI signatories
- interviews and desk research

SURVEY OBSERVATIONS

The following observations are based on a survey conducted by the PRI and VentureESG between June and July 2021. The 104 venture capital GP respondents were mainly PRI signatories or members of VentureESG's working groups. Consequently, the results likely overestimate the extent of ESG practice and understanding in the broader industry.

DRIVERS FOR DEVELOPING RESPONSIBLE INVESTMENT PRACTICES

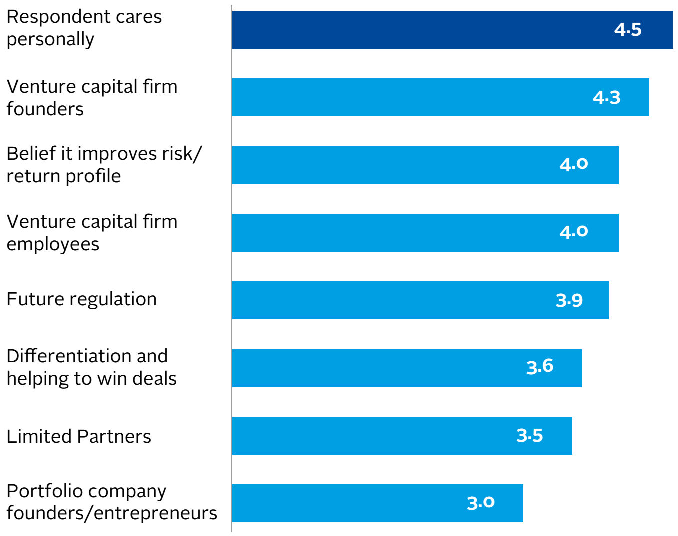
The biggest drivers of interest in ESG incorporation are:

- Senior leaders of venture capital firms
- A belief that ESG incorporation improves a fund's risk/return profile
- Employees of venture capital firms caring about it personally

Interest in responsible investment differs geographically, with momentum and practice stronger in Europe.[24] In the US, ESG incorporation is often seen as a box-ticking exercise and scepticism about its value is prevalent, as we will explore in the Challenges section.

24 The presence of European Union-backed asset owners such as the European Investment Fund (part of the European Investment Bank), that provide investment from public sources of capital and are focused on responsible investment, has perhaps played a part in this trend.

Figure 2: Current drivers of ESG incorporation in venture capital (Ranked from 1 – 5, where 1 represents the least likely and 5 the most likely).



Unlike public equity and fixed income markets, shifts in venture capital are primarily driven by changes in the preferences of start-up founders, with interviewees suggesting that a growing interest in responsible investment by them could also be a significant future driver.

Top venture capital GPs compete for start-up founders rather than LPs – if founders begin to prefer venture capital GPs that can partner with them to improve their management of ESG risks, then having responsible investment credentials may become a competitive advantage for venture capital firms.

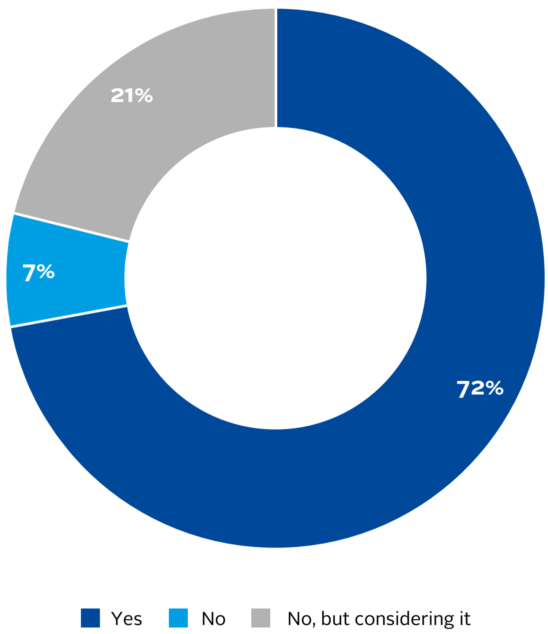
Respondents added that early-stage companies are increasingly likely to show more interest in ESG practices because they need to attract talented employees that want to align their values with those of the companies they work for. This is particularly important in the technology industry, where competition for talent is extremely fierce.[25]

Unlike other asset classes, LP engagement is not considered a major influence, nor was it cited as a strong future driver. Respondents also said that regulation – such as the Sustainable Finance Disclosure Regulation – is likely to push the venture capital industry to adopt responsible investment practices. More information on SFDR can be found in the PRI's briefing note.

RESPONSIBLE INVESTMENT POLICY

Almost three-quarters (72%) of respondents said that they have a responsible investment or ESG policy at their firm. Of those that did not, most said they were considering one. This is surprisingly high. As many policies are not publicly available, their quality – in terms of rigour, oversight, and implementation – cannot be assessed.

Figure 3: Do you have an ESG or responsible investment policy?

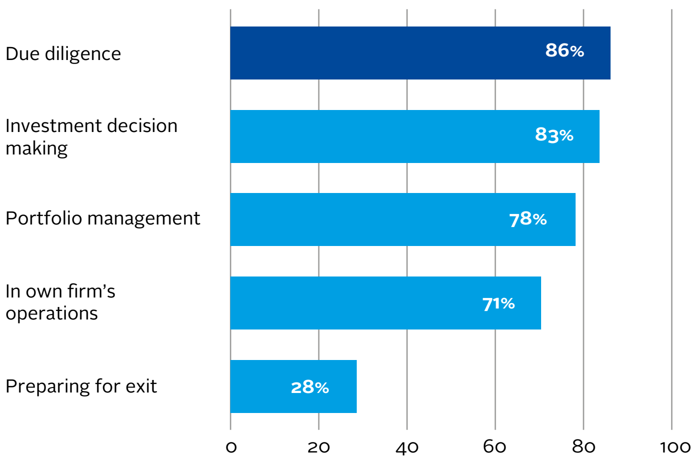


25 IMF (2019) Tech Talent Scramble

ESG INCORPORATION

Most respondents said they incorporate ESG factors in their investment processes during the due diligence, decision making, and monitoring stages. Far fewer consider them when preparing for an exit.

Figure 4: Do you integrate ESG factors into the following stages of your investment process?



Respondent approaches to ESG incorporation

Respondents were able to provide more detailed information on their approaches, some of which we highlight below as examples of current practice, categorised as:

- **systematic approaches** that incorporate ESG factors across the investment process
- **targeted approaches** that focus on specific material issues; and
- **outcomes-oriented approaches** that are linked to frameworks such as the SDGs.

Systematic approaches

"We incorporate ESG factors into our investment and ownership activity. We systematically include them in investment analysis and decisions, apply filters to potential investments to rule them in or out of contention and discuss ESG issues with companies to improve their handling and facilitate their resolution."

"We have an ESG integration procedure to ensure that ESG factors, where material, are considered during investment selection and management. We have also recently developed a tool to structure our ESG analysis, monitoring and engagement activities. This is part of our endeavour to design an ESG integration approach that is suited to the needs of early-stage companies, with consideration for the substantial differences between companies in the stages from seed to maturity, in terms of what is required and what can reasonably be asked from them."

Targeted approaches

"We look for team diversity and having a plan to improve this moving forward. We also review data practices to ensure the technologies used will not lead to any human rights violations."

"We use a questionnaire to identify and prioritise key ESG and ethical risk areas specific to our sector. We may also discuss these in more depth with founders."

"We screen companies for responsible use of technology, use a third party to assess team culture and founder leadership potential (including to manage a team well), and have targets for the percentage of deal flow from female and BAME founders."

Outcomes-oriented approaches

"We make sure that potential portfolio companies' missions track to the UN SDGs. We also try to calculate an investment's potential impact using the Impact Multiple of Money framework during due diligence and throughout the investment's lifecycle."

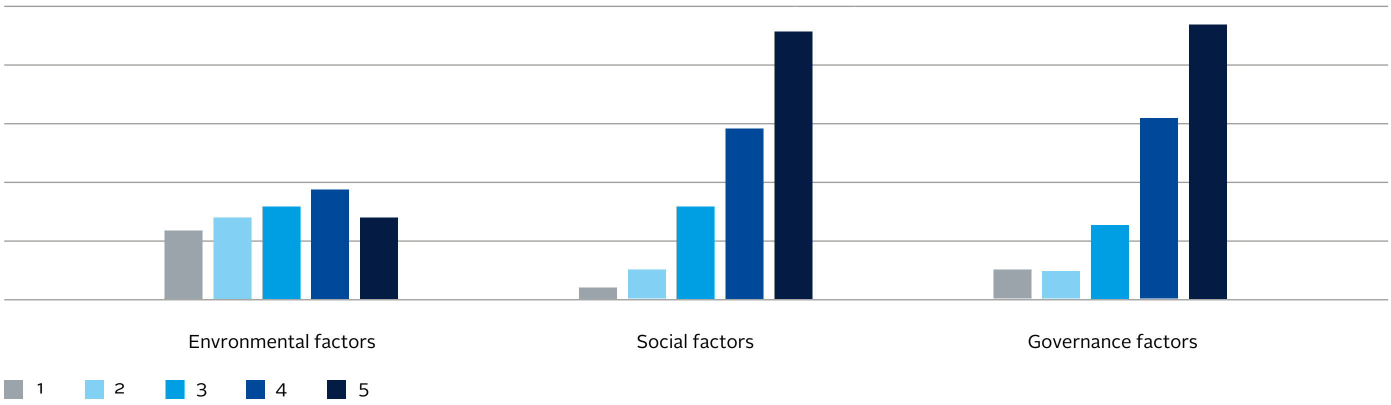
"We review each investment against the SDGs. We have also created a questionnaire with 70+ questions based on PRI research, the SDGs, new EU standards and other leading ESG/impact thought leadership papers."

"We target investees with sustainability outcomes. We use external consultants to assess sustainability outcomes and ESG profile/risks. We include ESG requirements in our investment process and documentation and work with investees to improve their consideration of ESG factors."

RELATIVE IMPORTANCE OF ESG FACTORS

Survey respondents indicated that they consider social and governance factors to be more important than environmental ones, corroborating some of our other investor discussions and highlighting the need to establish a dialogue with the industry around the environmental impact of technology.

Figure 5: Which factors do you consider important to assess for your portfolio companies? (Ranked from 1 – 5, where 1 represents the least important and 5 the most important).



Respondents could provide more detailed, additional responses explaining how they assess ESG factors. A selection of these are detailed below.

Assessment of environmental factors

"All potential investments are assessed against our Values Scorecard, which includes environmental impact and climate change. We seek to avoid investing in companies with material climate-related risks and target those that will have a positive or neutral climate impact. Any potential risks would be monitored and raised through our interactions with the board."

"We primarily focus on what impact the business would have at scale."

"As the businesses we invest in are at an early stage and are not in categories that heavily use environmental resources, this is not a high focus."

Assessment of social factors

"All our investments have a social impact, and we have KPIs that we monitor regularly and report to our LPs."

"We measure DEI at the C-level, founder/co-founder and board levels, and use it to assess company ownership."

Assessment of governance factors

"We assess the diversity and independence of the board."

"We look at specific corporate policies and good practices for this stage, such as the presence of independent board members."

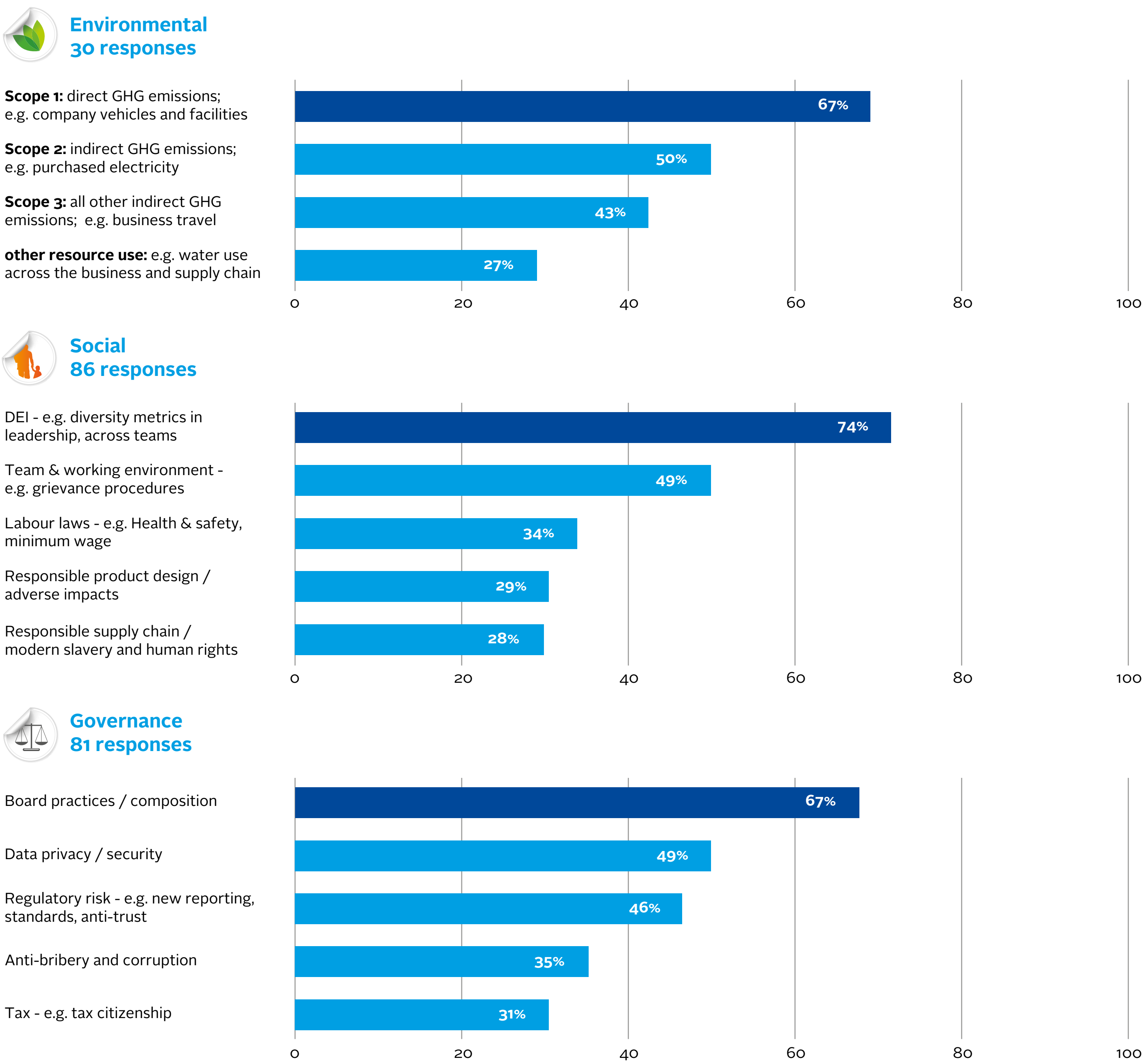
REPORTING

We asked respondents which ESG factors they received information on from their portfolio companies, which factors they reported to their LPs and which ones they tracked internally.

Portfolio company reporting to GPs

Overall, DEI and board practice and composition were the most reported factors. More broadly, social and governance factors received more than double the number of environmental responses.

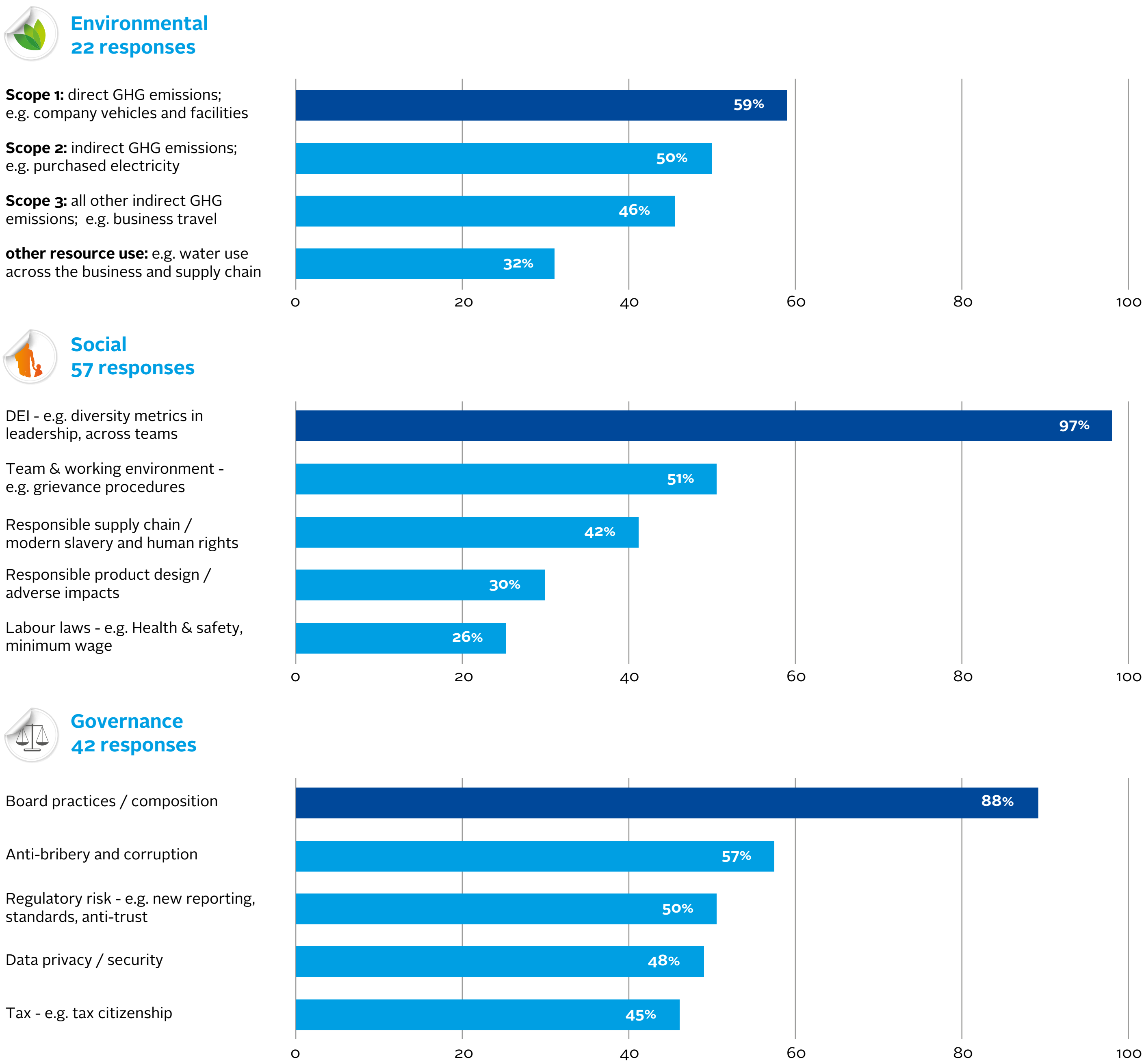
Figure 6: Most commonly reported ESG factors.



GPs reporting to LPs

Venture capital managers also tend to provide their LPs with more investment information on social and governance factors than environmental factors.

Figure 7: Most commonly reported ESG factors.



Internal monitoring

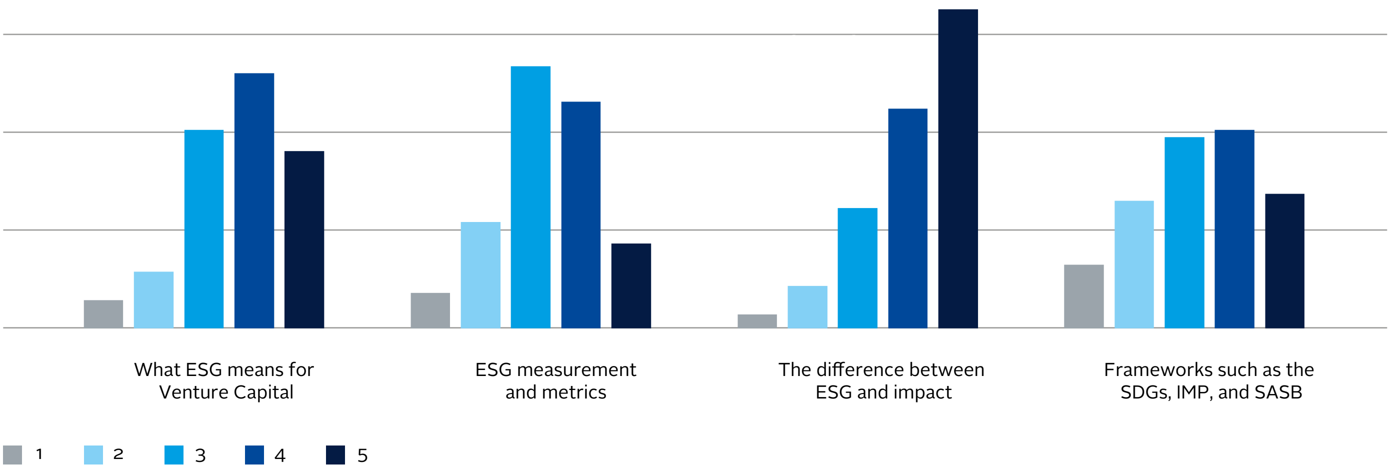
GPs reported monitoring their own DEI and board practices more than any other factors. Respondents indicated that this allowed them to set a good example for their early-stage companies.

This approach is becoming more widespread in the broader private equity industry, where GPs find it helpful to point to their own activities when asking portfolio companies to undertake work such as measuring their carbon footprints.

ESG-RELATED KNOWLEDGE AND EXPERIENCE

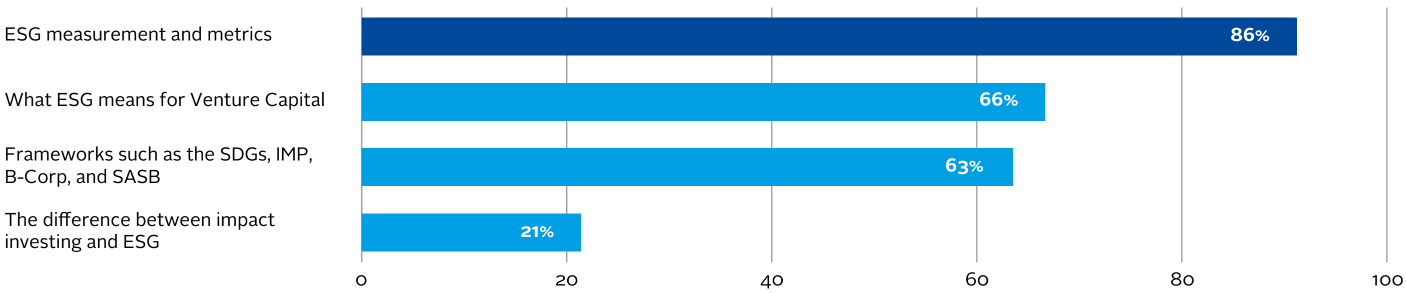
The survey asked respondents about their degree of ESG knowledge. Most were relatively confident of their ESG credentials in several areas. However, in many cases, those with ESG responsibilities are not senior investment decision makers. Neither are they in full-time ESG roles. Resources at venture capital firms are much more constricted than at buyout firms, and having dedicated ESG headcount is often not prioritised.

Figure 8: How would you describe your ESG knowledge? On a scale of 1 - 5, where 1 = little to none and 5 = advanced.



Respondents also indicated a strong interest in learning more about ESG incorporation, target setting and using the SDGs and other frameworks to inform their investments. The PRI will seek to address this in future work – see Next steps for more detail.

Figure 9: Interest in further learning.



INTERVIEW OBSERVATIONS

At a high level, ESG incorporation practices within the venture capital investment process are similar to those of buyout and growth capital but are generally less sophisticated and resource intensive. While there are some examples of more complex ESG incorporation approaches, these are not the norm.

Figure 10: The venture capital investment process.

PRE-ACQUISITION – POLICY, DEAL SOURCING, AND INVESTMENT DECISION

Responsible investment policies

Some venture capital GPs interviewed have formal responsible investment policies that establish the scope and nature of their ESG incorporation approaches – such as UK-based manager Atomico.

However, they are often less robust and comprehensive than other asset classes and are not always publicly available. Some GPs have policies covering specific ESG topics such as DEI or anti-harassment without having an overarching responsible investment policy.

Many non-PRI signatories interviewed said they incorporated ESG factors into their investment processes in a less formalised way and did not have a policy to guide their work.

Screening

Some GPs and LPs use exclusion lists to conduct screening[26] but this is not always the case. Venture capital firms caution that generic exclusion lists used in other asset classes, such as the International Finance Corporation Exclusion List, are often unsuitable. Such lists focus on risks unlikely to attract venture capital – such as weapons production – and miss out some controversial areas that the sector might be exposed to. GPs cited being asked to adhere to these as evidence that LPs do not always understand the asset class well.

The risks associated with using traditional exclusion lists in venture capital can be illustrated with the recent case of NSO Group, a surveillance technology company whose software purportedly helps governments prevent and investigate terrorism.

NSO's main product, Pegasus, has been implicated in the activities of certain governments, with claims it has been used to spy on journalists and human rights activists.[27] NSO was backed by venture capital and later-stage private equity investment. Investors that might wish to avoid similar investments need an exclusion list that is fit for purpose.

Some venture capital GPs have developed tailored exclusion policies that better reflect their investment universe:

- **Amadeus Capital Partners** avoids investments in various sectors and/or business models, including those linked to gambling, predatory credit and debt traps, addictive forms of gaming, and facial recognition technology.
- **Truffle Capital,** a life sciences and tech investor, does not invest in companies whose scientific processes "lead to ways of modifying human beings".

"In biotechnologies, scientific advances can lead to ways of modifying human beings that Truffle Capital deliberately refrains from investing in [...particularly] non-ethical procreation, the modification of brain functions to modify performance rather than to treat a pathology, potentially addictive molecules or viral vectors that can be used for terrorism."

26 For more information on the use of screening in responsible investment, see PRI (2020) An introduction to responsible investment: Screening

27 The Guardian (2021) How NSO became the company whose software can spy on the world

Due diligence

Although some interviewees described venture capital as due diligence-light, many firms noted that they engaged formally and informally with start-up founders before investing to mitigate potential future ESG risks.

Some investors use pre-investment ESG questionnaires to identify and understand the ESG risks and opportunities a potential investee is exposed to. These range significantly in content, complexity, and the resources required to complete them.

Some focus on material ESG factors by using Sustainability Accounting Standards Board (SASB) standards. However, one venture capital investment manager signatory includes 94 ESG KPIs in its survey. Such large data requirements are rare and, for start-ups unfamiliar with responsible investment – probably quite unpalatable, given their lack of dedicated resources (see Survey observations and Challenges).

Other investors use more informal methods, with one noting that they try to assess a founder's values and ethics by observing their behaviour towards others – for example, at a restaurant. Doing so can help identify any concerning traits (such as misogynistic behaviours) that might feed into the culture of a start-up and subsequent business.

Given the poor track record of sexual harassment and other DEI issues in the venture capital and technology industries (see DEI and the venture capital industry), venture capital GPs and LPs need to develop more rigorous due diligence processes to identify and assess this risk.

For example, many private equity firms engage third parties to conduct detailed background investigations on key personnel at prospective portfolio companies.

Deal documentation

While not widespread, some venture capital GPs include ESG language – for example, sustainability clauses – in deal documentation such as term sheets and shareholder agreements as standard. Others aim to include them on a best-efforts basis, dependent on factors including a deal's competitive dynamics and founders' views.

ESG language is also sometimes found in separate documentation, outside of term sheets and shareholder agreements. While not legally binding, this helps establish a common understanding of GP and early-stage company values.

Examples of template language for deal documentation can be found in Obvious Venture's World Positive Term Sheet or the climate-focused VC Sustainability Clause from Leaders for Climate Action, which has been adopted by a range of German venture capital GPs.

Investment decision making

Some of the venture capital GPs interviewed said they include an ESG section in their investment committee documentation. For example, UK manager Balderton Capital has a section dedicated to its Sustainable Future Goals, a framework consisting of ten ESG goals aligned with the SDGs.

Partners on the investment committee consider this information when voting on whether to pursue an investment or not. In one case, Balderton decided not to invest in a successful business because of concerns around the start-up founder's values and the potential negative social outcomes the company might contribute to had it scaled dramatically.

Even where more systematic and formalised integration is lacking, there are examples of good practice at the investment committee stage on a more ad-hoc basis. For example, one interviewed GP explained how it sourced an early-stage company whose primary business was vaping. It highlighted and discussed at length the ESG risks and opportunities of such a business but determined the risks were too great and could not be mitigated. Therefore, it passed on the investment opportunity.

LP PRACTICES

Below are some examples of LPs that have developed venture capital-specific due diligence practices:

- While it is common for managers to lack ESG policies and practices, the **San Francisco Employees' Retirement System** (SFERS) uses a pre-investment questionnaire to assess GPs' ESG capabilities. Its ESG team reviews the responses it receives and prepares follow-up questions, to be discussed on a call with each GP. SFERS scores firms using its proprietary framework and prepares overall assessments, which it submits to its investment committee. It identifies follow-up and future engagement topics and provides relevant information (minus the ESG score) to its full board.
- Another **US state pension plan** tailors its ESG incorporation approach for all asset classes, including venture capital. It has no expectations for investment managers targeting pre-revenue companies. However, it has a dedicated ESG call with every prospective GP to build an ESG profile describing and analysing how its current ESG program has evolved and its future roadmap. This information is included in investment committee documentation. The pension plan also tailors its proprietary scorecard for venture capital. While scorecard topics are the same for all asset classes, they are calibrated for factors such as manager size and geography. Expectations for seed to series B/C investments are low due to the size of the early-stage companies involved. For example, ESG KPIs are not expected, but "tone at the top", responsible investment policy, and DEI are all considered and rated (poor, fair, strong, excellent). The LP undertakes a more comprehensive assessment for GPs making series C investments and beyond, focused on DEI, decent work, and cybersecurity.

Not all LPs tailor their ESG manager assessments to venture capital, however. Many use ESG due diligence questionnaires and scoring frameworks taken from other areas of private equity, such as buyout strategies. These are not always appropriate, according to the venture capital GPs interviewed, and can result in a lack of engagement. This is a major barrier to further ESG incorporation in the industry and is discussed further in the next section (see Challenges).

POST-ACQUISITION – INVESTMENT HOLDING PERIOD

Many venture capital GPs are hands-on investors seeking to bring their own experience of growing businesses to the early-stage companies they invest in. Like growth equity and buyout, this approach lends itself to helping them improve their management of ESG risks and opportunities.

Surveys

Venture capital GPs that incorporate ESG factors often conduct annual surveys of their investees to monitor their ESG risks:

- **Atomico** completes a one-page Values Scorecard six months after it makes an investment and then on an annual basis until exit, allowing it to monitor its portfolio-wide risks. The scorecard is used to uncover red flags in diversity, environmental impact, the early-stage company's future impact at scale, and governance matters. Atomico says it is not prescriptive and empowers its investment team and start-up founders to discuss positive and negative issues in these areas.
- Swedish investor **Kinnevik** uses its survey to track and publicly publish ESG KPIs.

Ideally, the results of such surveys should form part of GPs' investment monitoring, in quarterly portfolio review meetings, for example, rather than being addressed separately.

STANDARDISING ESG DISCLOSURES IN THE VENTURE CAPITAL INDUSTRY

As mentioned in the Market overview section, a small number of industry initiatives are underway seeking to standardise venture capital portfolio company ESG questionnaires and KPIs. While interviewees welcomed these initiatives, they cautioned that a proliferation of competing standards would not be conducive to growing responsible investment practice across the industry.

Some venture capital ESG surveys and KPI reporting frameworks are very wide-ranging and lack a focus on financial materiality. Lengthy surveys that go well beyond financially material ESG factors would seem contrary to what interviewees often cited. The venture capital industry is highly focused on activities that create value, and there is a dislike for anything viewed as a box-ticking exercise. Additionally, factors that might slow down the investment process are viewed negatively.

Disclosure requests should be tailored appropriately to the growth stage of investments, and collecting decision-useful data should be the priority. While surveys can create transparency and help venture capital firms collect ESG data, GPs need to develop additional mechanisms and capabilities to ensure they take action in portfolio companies where the data indicates it is required.

Policies

Venture capital GPs can help early-stage companies establish and implement codes of conduct and other policies, such as those focused on anti-harassment or DEI, when they are ready to employ staff.[28] However, this is not yet widespread.

Indeed, some consider it anti-entrepreneurial or unnecessary to have such policies in place at an early stage. Conversely, some interviewees pointed to the relative ease and low cost of implementing such policies at an early stage, versus the potentially huge future costs associated with harassment or other issues that a company could face if it does not have the appropriate governance measures in place to deal with such incidents.

Establishing whistleblower processes is also an important tool to encourage a culture where wrongdoings can be rapidly addressed. This can include setting up communication channels that can be used should incidents of harassment, or other types of violations, occur.[29]

For example, **Vintage Investment Partners**, an Israeli venture capital fund of funds, includes the email and phone number of a retired judge on its website that anyone, from either the venture capital funds in which they invest to the employees of underlying companies, can contact. It states:

"As party to the initiative on addressing and eradicating 'Sexual Harassment and Predatory Conduct in Israeli Venture Capital Funds', Vintage Investment Partners has adopted a 'zero-tolerance' approach to any predatory practices by an investor against an entrepreneur seeking capital. If you have been faced [with] or suspect sexual harassment and predatory conduct by any Vintage Investment Partners personnel, you are encouraged to report such conduct immediately to retired Labor Court Judge, Dina Efrati, who has been appointed by the Israeli venture capital funds party to the initiative, to serve as ombudsman for anyone who has a sexual harassment claim against any of the funds."

Education

Venture capital GPs can engage their early-stage companies to educate them on the ESG risks and opportunities they may be exposed to. For example, **Atomico** has developed Conscious Scaling, a framework for dialogue between start-up founders and investors or boards, focused on identifying and mitigating long-term risks associated with a business model or technology's impact on society, the environment, and all stakeholders.

GPs can also convene individuals from their early-stage companies at events – dubbed by some interviewees as ESG days – to learn from each other and discuss their ESG approaches. However, unlike in the buyout industry, this practice is not widespread among venture investors.

EXIT

It is unusual for venture capital GPs to communicate information about ESG factors to potential buyers of their portfolio companies.

However, responsible investment practice continues to advance across financial markets. As potential buyers, such as private equity firms or stock exchanges, increase their ESG expectations, the onus will be on later-stage venture capital GPs to ensure that their portfolio companies meet these. For example, Nasdaq has introduced new board diversity requirements for companies listing on its exchange.[30]

USE OF CORPORATE STRUCTURE TO ADVANCE ESG PRACTICE

Some venture capital GPs and their early-stage companies are choosing to pursue different corporate structures, for example, the Delaware Public Benefit Corporation (PBC), or B-Corp certification. Among other requirements, PBCs must balance the interests of shareholders with other constituencies affected by the business's conduct. While few PBCs have listed publicly, there are successful examples, for example, the IPO in 2020 of online insurer Lemonade, a tech start-up backed by SoftBank.[31]

28 The NVCA has a range of DEI-related policies.

29 The PRI has published guidance on this topic. See (2020) Whistleblowing: Why and how to engage with your investee companies for more detail.

30 CNBC (2021) SEC Approves Nasdaq's Plan to Boost Diversity on Corporate Boards

31 Columbia Law School Blue Sky Blog (2020) Lemonade, Inc.: Harbinger of Future Public Benefit Corporation IPOs?

CHALLENGES

KEY TAKEAWAYS

- There is a perception among some GPs and investee companies that ESG issues are not material to venture capital – due to its early-stage nature and the high failure rate of investments.
- GPs' influence on investees can be limited, particularly if they take a founder-friendly approach to winning investments. Similarly, LP-GP dynamics are often skewed, with asset owners that conduct ESG due diligence considered difficult by some venture capital firms.
- The venture capital industry does not have a strong culture of client – or public – disclosure, with firms regulating information flows very tightly. GPs that do collect ESG data do not always report it to LPs, making monitoring and engagement on those risks difficult.
- Survey respondents want to better understand how to set relevant ESG metrics and targets in venture capital, but there are few tailored resources available.
- Venture capital GPs and LPs need more opportunities to collaborate with peers and raise standards within the asset class.

There are significant barriers to incorporating ESG factors in the venture capital investment process, with 83% of respondents to our survey reporting that they find it difficult to do so.

This section will explore the following challenges, informed by our survey responses, interviews and broader research:

- Early-stage company investments
- Lack of influence
- Venture capital business model
- Lack of transparency
- Lack of tailored common metrics, frameworks, and guidance

EARLY-STAGE COMPANY INVESTMENTS

Early-stage companies with limited resources and rapidly evolving business models tend to be focused on growth and product design, often to the detriment of other areas. According to interviewees, convincing them that ESG issues are material is challenging. Investors also expressed concern that ESG requirements would overburden start-ups that may not even have employees or be generating any revenue.

To address this challenge, GPs (and their LPs) need to be pragmatic and tailor their ESG expectations accordingly, recognising that certain tasks will be more feasible or realistic once companies grow, attract further funding rounds beyond series A, take on employees, and start professionalising.

Based on our conversations, venture capital GPs also often feel their investments are low in ESG risk. They view their early-stage companies as providing solutions to problems. Therefore, many GPs are not convinced that ESG incorporation adds value and see it as a box-ticking exercise that exists to satisfy LP and other stakeholder demands.

Nonetheless, venture capital GPs should recognise that investing in early-stage companies provides an opportunity to influence and instil good ESG practices from the outset.

As such, GPs can still work with investees at the earliest stages to lay a strong foundation for future growth, for example, by mentoring start-up founders to create a positive company culture and strong DEI practices.

Investors should also consider the actual and potential negative future outcomes of business models on external stakeholders (beyond employees), such as consumers, communities and suppliers. Research shows that in the UK 28% of tech workers have seen decisions made about technology that they felt could have negative consequences for people and society – 18% of those went on to leave their companies as a result. The British Standards Institution launched the first Corporate Governance Guide for Responsible Innovation in 2020. This allows organisations to demonstrate they are innovating responsibly. Asking focused questions of founders can help establish the social and environmental risks a company could be exposed to once it reaches scale.

Thinking through the negative impacts a company may have as it scales can potentially help avoid these issues developing in the future, particularly as these can be difficult for other investors further along the investment chain to change if they are already ingrained.[32]

32 Forbes (2019) The Venture Capital Blind Spot

LACK OF INFLUENCE

Unlike buyout investments where investors have control of the company, or growth investments, which often come with board seats and a range of other governance rights, venture capital GPs are minority shareholders whose influence can often be limited.

INVESTEE RELATIONSHIPS

GPs pursuing a founder-friendly approach to venture capital (see Market overview) believe that engaging with their early-stage companies to better manage ESG risks or opportunities, for example, by setting KPIs or specific policies, could reduce their competitiveness when sourcing and winning investments.

Often founders want to be left alone to run their businesses, and where funding dynamics are in their favour, they may choose to accept the investment that comes with the least conditions, giving rise to a rather passive investment strategy that does not lend itself well to ESG incorporation.

Nonetheless, anecdotal evidence from our research suggests that some founders are becoming more interested in ESG issues and seek input on the topic from GPs.

Venture capital GPs that undertake responsible investment also highlight that their ESG expertise helps them stand out from competitors and win deals. This message needs to be more widely communicated to advance understanding and normalise ESG incorporation as a value-added undertaking.

BOARD SEATS

Venture capital portfolios can be large, with some GPs monitoring investments in more than 30 early-stage companies at one time. Where investment team members take board seats, they are spread thinly and may not be as engaged as some of their growth equity or buyout peers, who might sit on fewer boards.

Furthermore, interviewees noted that GPs only interact with later-stage investee companies at a board level, and too much deference is often paid to company management. This lack of in-depth engagement can lead them to overlook ESG issues that do not fall within a board's remit, such as overtime practices and minimum pay.

LP / GP DYNAMICS

> "[I] cannot overemphasise how little influence LPs have over the most successful venture capital GPs."

This lack of influence arises from two factors:

1. The most successful venture capital funds might return in the region of 10x invested capital and are therefore highly sought-after.
2. Venture capital funds have limited capacity to accept investments, leading to an environment where LPs are extraordinarily motivated to access the most successful funds and often do not want to be seen as difficult, for example, by undertaking ESG due diligence.

> "There is a clear expectation that the role of LPs is to grovel for as much allocation as they can and not to make any demands"

LP concerns are not unfounded. One source recounted that a long-term US state pension plan investor in a successful venture capital fund only found out about its latest fundraise through media reports after the fund had closed. During a prior fundraising, the LP had questioned the fund's fee structure, prompting the GP to exclude it from the subsequent fundraise.

> "You have no teeth, so what next?"

Although venture capital GPs see an increasing flow of ESG DDQs and other requests for information through templates such as ILPA's Diversity Metrics Template, many either don't respond to these or provide very superficial answers.

Even when LPs do receive responses to their ESG DDQs, it most often has little impact on the ultimate investment decision. LPs in buyout funds routinely engage with GPs and take a collegiate approach to helping them develop ESG practices. Due to the dynamics discussed here, this does not often occur in venture capital.

EXCEPTIONS TO THIS DYNAMIC

These dynamics do not necessarily apply where an investment manager's capital is constrained – for instance, those raising first-time funds or whose firms do not have a top-decile performance track record. LPs have a much greater degree of influence in these circumstances as their capital is needed for the venture capital firm to get started or remain viable.

Furthermore, some large and sophisticated LPs that were interviewed told us they are happy to engage with venture capital firms on ESG topics, albeit it appears to be light touch, cognisant of the risks described above.

Certain types of asset owner, such as hospital or university endowments, potentially yield more influence because venture capital GPs often see making financial returns for such institutions as a critical part of their mission and take their views more seriously as a result.

Overall, the GP/LP dynamics described are a difficult challenge to address. However, there is increasing recognition among interviewees that the attractiveness of venture capital to LPs is cyclical and that GPs need to prepare for when the cycle turns and commitments to their funds are more difficult to access.

VENTURE CAPITAL BUSINESS MODEL

The venture capital model itself also presents serious barriers. Many stakeholders question the value of ESG incorporation across a portfolio where:

- up to 75% of start-up companies fail;
- a growth-at-all-costs mindset is dominant, and sees huge amounts of capital invested into companies that struggle to be profitable.[33]

As a result, venture capital firms are reluctant to invest in dedicated ESG headcount. The pool of professionals with deep experience of ESG incorporation focusing on early-stage companies is also limited. This is also reflected across LPs, service providers, and other stakeholders. Collaboration among these groups, and between venture capital peers, on ESG topics could help to improve this issue.

Additionally, as a small number of successful investments drive overall returns, some venture capital funds invest in a high number of companies to increase the chances of a successful investment, making ESG incorporation challenging, especially where internal resources are constrained.

Paradoxically, using a systematic ESG incorporation approach could ensure that more risks are identified, and that company engagement is prioritised on a risk-adjusted basis, thereby reducing the overall failure rate.

LACK OF TRANSPARENCY

The venture capital industry does not have a strong culture of client – or public – disclosure, with firms regulating the flow of information very tightly. This is not just ESG related – for example, one GP explained that they only report fund-level investment performance to LPs, rather than disclosing the performance of individual holdings.

Venture capital GPs that collect ESG data do not always report it to LPs, making it difficult to monitor and engage on those risks.

Encouraging more venture capital investors to become PRI signatories and report on their responsible investment practices could be a good way to tackle this reticence around disclosure.

LACK OF TAILORED COMMON METRICS, FRAMEWORKS, AND GUIDANCE

The majority (86%) of our survey respondents want to better understand how to set relevant ESG metrics and targets in venture capital, but there are currently few resources available that are tailored to the asset class.

Although broader industry frameworks such as SASB and Global Reporting Initiative can be helpful, they are not always appropriate. For example, SASB standards may be better suited to larger companies. Guidance on ESG incorporation practices is not often tailored to venture capital either.

Industry initiatives to develop venture capital-specific metrics and frameworks are emerging (see Emerging initiatives and guidance). This is an encouraging sign of increasing ESG interest, but a proliferation of competing standards would not benefit anyone and must be avoided.

Investment and ESG professionals at venture capital firms and asset owners also need more opportunities to collaborate with peers and raise standards within the asset class. The PRI is well placed to convene investors for that purpose.

33 The Financial Times (2021) Does Uber Deserve its $91bn Valuation?

NEXT STEPS

For responsible investment to flourish in the industry, understanding and knowledge about its application and benefits must improve at all stages of the venture capital funding spectrum and investment process.

The PRI will consider taking a number of steps to contribute to this effort, as outlined below.

BROADENING UNDERSTANDING

We will aim to work with our global signatory base of asset owners and venture capital managers to broaden their understanding of ESG incorporation in venture capital by:

- convening GPs and LPs via our Venture Capital Network (join here) and building a community of practitioners that work together to address barriers and improve leading practice;
- providing other forums to discuss issues and provide guidance.

SHARING BEST PRACTICE

We will help venture capital investment managers share leading ESG incorporation practices, address the challenges they face and learn from peers by delivering content and events such as case studies, podcasts and roundtables.

CONVENING ASSET OWNERS

We will investigate ways to convene and encourage LPs to better engage with the venture capital industry on ESG matters.

DRIVING STANDARDISATION

We will work towards developing and providing standard tools for venture capital investors by:

- assessing the desirability and viability of a PRI LP ESG DDQ tailored to venture capital;
- supporting initiatives that are working towards establishing industry-appropriate ESG frameworks.

We welcome feedback that can be used to take our venture capital work forward – contact vc@unpri.org to contribute to the discussion.

CREDITS

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The Principles for Responsible Investment (PRI)

The PRI works with its international network of signatories to put the six Principles for Responsible Investment into practice. Its goals are to understand the investment implications of environmental, social and governance (ESG) issues and to support signatories in integrating these issues into investment and ownership decisions. The PRI acts in the long-term interests of its signatories, of the financial markets and economies in which they operate and ultimately of the environment and society as a whole.

The six Principles for Responsible Investment are a voluntary and aspirational set of investment principles that offer a menu of possible actions for incorporating ESG issues into investment practice. The Principles were developed by investors, for investors. In implementing them, signatories contribute to developing a more sustainable global financial system.

More information: www.unpri.org

PRI Principles for Responsible Investment

The PRI is an investor initiative in partnership with UNEP Finance Initiative and the UN Global Compact.

United Nations Environment Programme Finance Initiative (UNEP FI)

UNEP FI is a unique partnership between the United Nations Environment Programme (UNEP) and the global financial sector. UNEP FI works closely with over 200 financial institutions that are signatories to the UNEP FI Statement on Sustainable Development, and a range of partner organisations, to develop and promote linkages between sustainability and financial performance. Through peer-to-peer networks, research and training, UNEP FI carries out its mission to identify, promote, and realise the adoption of best environmental and sustainability practice at all levels of financial institution operations.

More information: www.unepfi.org

UN environment programme | finance initiative

United Nations Global Compact

The United Nations Global Compact is a call to companies everywhere to align their operations and strategies with ten universally accepted principles in the areas of human rights, labour, environment and anti-corruption, and to take action in support of UN goals and issues embodied in the Sustainable Development Goals. The UN Global Compact is a leadership platform for the development, implementation and disclosure of responsible corporate practices. Launched in 2000, it is the largest corporate sustainability initiative in the world, with more than 8,800 companies and 4,000 non-business signatories based in over 160 countries, and more than 80 Local Networks.

More information: www.unglobalcompact.org

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