Sustainable Investing

IDB Lab

A Playbook for VC Funds

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Sustainable Investing

A Playbook for VC Funds

Motivation

Sustainable investing means ensuring that investee companies and their activities have no significant negative impacts on people and the planet. Impact, whether positive or negative, direct or indirect, intentional or unintentional, results not only from a company's operations but also from its supply chain or products and services. While "doing no harm" might seem to be a given, the venture capital (VC) sector has persistent challenges regarding investing and doing business sustainably. Yet early-stage companies and VC funds implementing a consistent approach to managing *sustainability* can benefit from multiple competitive advantages.

For VC funds, a consistent approach to managing *sustainability* improves efficiency, predictability and planning, timeliness, and comparability among potential or current investments (ex ante vs. ex post or across sectors, among other characteristics). Besides facilitating decision-making, such consistency also increases transparency and accountability, as is increasingly demanded by stakeholders from investors to regulators and consumers. A consistent approach to *sustainability* and related requested data also reduces the reporting burden for investees, which yields higher-quality, more reliable data from which fund managers can continuously learn and improve. VC funds can then invest in companies that are both profitable and not harmful for people and the planet, the "bare minimum" in the path towards sustainable development that is increasingly linked to a strong financial track record.

For VC-backed companies, implementing a consistent approach to managing *sustainability* allows the identification and management of potentially significant risks to financial performance, funding sources, and reputation. Gathering and integrating social and environmental data, as is typical of *sustainability* management, can help improve decision-making and point the way for companies to develop more efficient, more sustainable products and operations that can better attract both consumers and talent.

Besides these clear benefits, the global climate crisis and widening social and economic inequalities mean that managing *sustainability* is a bare minimum, beyond just the right thing to do. Climate and social data leave large uncertainty about the future, and major efforts are needed if we want to pass that lowest bar. Today, investing responsibly requires integrating an approach to *sustainability* throughout the investment and portfolio lifecycle.

Venture capital currently lags other asset classes in terms of integrating a systematic approach to managing and effectively addressing *sustainability*. Why? First, the sector has lacked a clear, general understanding of what constitutes an approach to *sustainability* management. Existing efforts in ESG often focus only on financial materiality without working to address material negative impacts or the potential role and impact VCs can have on the world's most pressing challenges. Second, VC funds lack tools, standards, and principles that apply to their reality. Given the lack of clear norms and tools, and often left to their own devices, it is unsurprising that the asset class is behind others in implementing *sustainability* practices.

This Sustainable Investing Playbook was designed to remove these obstacles and empower VC fund managers with practical tools and resources to develop and manage responsible portfolios. Time is of the essence for VC funds and VC-backed companies; Sustainable Investing is a must but not yet a given!

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Overview

Purpose

For the purposes of this playbook, sustainable investing encompasses investing to achieve competitive, risk-adjusted financial returns while mitigating or reducing negative outcomes for people and the planet[1]. Sustainable investing extends beyond "responsible" or "ESG" investing by working beyond questions of financial materiality to benefit stakeholders with investments when possible, but not as a main goal or with intentionality (which is impact investing)[2].

This playbook provides a practical introduction to how venture capital ("VC") funds can embed *sustainability* considerations into their decision-making and other practices. As "do no harm" is the North Star of these considerations, a general direction and intent to follow, this playbook focuses on the *sustainability* goal of avoiding negative social and environmental impacts. The first in a series of two playbooks on how VC funds can contribute positively to sustainable development, it will be followed by the second, "Impact investing for VC Funds," which will focus on how VC funds can contribute positively to solve environmental and social challenges (related to yet different from "benefiting stakeholders"). Positive impact cannot be achieved without "do no harm" *sustainability*, so we begin with *sustainability* management as a first milestone in the journey towards positive impact.

Fund managers following this playbook should intend to act to avoid harm to people and the planet, thus encompassing all material potential significant negative environmental and social impacts beyond the financial value (enterprise value) of their investments. In practice, fund managers must make decisions from a set of options with inevitable tradeoffs and limited information; thus, some harm may be difficult to avoid. When that is the case, fund managers should seek

1. For a helpful visual representation of these definitions, see Impact Investing Institute, "The Spectrum of Capital," https://www.impactinvest.org.uk/wp-content/uploads/2020/11/Spectrum-of-capital-general-version.pdf.

2. The Global Impact Investing Network's "Core Characteristics of Impact Investing," published in 2019, establish four baseline expectations for impact investing. By this definition, impact investors: (a) invest with intentionality, or an intentional desire to contribute to measurable social or environmental benefit; (b) use evidence and impact data in investment design; (c) manage impact performance; and (d) contribute to the growth of the impact investing industry. A hallmark of impact investing is the investor's commitment to measure and report the social and environmental performance and progress of their underlying investments, ensuring transparency and accountability while informing the practice of impact investing and building the field. For more, see the Global Impact Investing Network (GIIN), "Core Characteristics of Impact Investing," https://thegiin.org/characteristics, and GIIN, "What Is Impact Investing," https://thegiin.org/impact-investing/need-to-know/#what-is-impact-investing.

to ensure no significant harm is done in line with the EU taxonomy and other regulations (see Box 1) and reduce any identified harm as soon as possible. In general, fund managers should focus on making decisions that prioritize acting to avoid harm. Flexibility and continuous improvement are at the core of *sustainability* management, a system that seeks constant optimization to achieve stated *sustainability* goals.

While this playbook helps VC funds begin to implement or to advance their existing practice of *sustainability* in their day-to-day operations consistently and effectively, funds will likely need additional guidance tailored to their sector or geography.

The overarching question is: how can VC funds embed *sustainability* **considerations into their decision-making and practice?** The playbook defines *sustainability* management, explains why it is important, and describes how to implement *sustainability* practices into fund strategy, management, reporting, and governance. The approach leverages existing ESG and impact standards, tools, and resources and is aligned with the SDG Impact Standards for Private Equity Funds, the only practical standard on integrating impact goals into the decision-making and day-to-day operations of private equity funds. While useful for improving transparency, this playbook focuses not on reporting but rather on decision-making and management.

Audience, Geography, and Scope

This is an introductory document intended for VC funds in general. While often referring to statistics and use cases from VCs in Latin America and though it may be more generally applicable to VC funds in emerging markets, the approach applies to any VC fund. We welcome feedback and collaboration to continuously improve this playbook and would especially welcome additional case studies and examples.

We do not address and expect sustainable funds would exclude commonly screened-out business activities, such as the following:[3]

- Any product or activity deemed illegal under applicable local or national laws or regulations or subject to internationally agreed phaseouts or bans as defined in global conventions and agreements, such as certain: (a) hazardous chemicals, pharmaceuticals,

3. As aligned with the CDC Group's ESG Toolkit. "CDC's Code of Responsible Investing, Schedule 6: Excluded Activities," https://toolkit.cdcgroup.com/working-with-cdc/code-responsible-investing/.

pesticides, and wastes; (b) ozone-depleting substances; (c) endangered or protected wildlife or wildlife products; and (d) unsustainable fishing methods;

- Arms (weapons, munitions, or nuclear products);
- Unbonded asbestos fibers;
- Radioactive materials;
- Prostitution;
- Gambling, gaming casinos, and equivalent enterprises;
- Tobacco or tobacco-related products; and
- Pornography.

Methodology

To develop the playbook, we engaged in the following research activity:

- Extensive literature review of 11 internationally recognized standards, principles, tools, and guidance for responsible and sustainable investing. *(For an overview of the resources assessed, see the Appendix.)*

- One-on-one interviews with stakeholders from VC funds in Latin America, including ALIVE Ventures, Cometa, Salkantay Ventures, Vox Capital, and IDB Lab.

- Gathered feedback from a wide range of practitioners and experts in the field.

A first draft of the playbook was shared with a wide range of experts and practitioners. The current version integrates more than 80 comments received.

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Introduction

Sustainable investing sets the expectation that all investee companies, regardless of stage, type, size, or sector, ultimately have no material negative social and environmental impacts, including at their expected later stages of development. As VC funds invest in startups, they can set this expectation and support early-stage companies on their journey to achieve financial growth without significant harm to people and the planet.

In focusing on funds seeking to act to avoid significant harm, this playbook covers the application of sound ESG risk-management practices and the identification of potential negative impacts beyond traditional ESG approaches.

Figure 1: Continuum of Investment Approaches

In simple terms, the management of *sustainability* is located within "act to avoid harm."

Legend:

Contribute to solutions: Help tackle sustainable development gaps, for instance contribute to solving poverty or reducing hunger in developing countries

Benefit Stakeholders: Seek a positive effect on planet and people

Avoid harm / do no harm: Act to avoid negative impact on people and planet

ESG/Financial Materiality: Consider impact on planet and people in reference to how it affects the financial *sustainability* of the organization, that is, factors that may affect the bottom line in the near or longer term

Business as usual: Seek profit irrespective of the organization's impact on planet and people.

Why is managing sustainability important for VC Funds?

Integrating the management of *sustainability* into investments benefits VC funds in several ways:

- **The bare minimum for a sustainable private sector and economy, given urgent global crises**. The climate and social crises require immediate action at scale. Investors must be aware that every investment has impacts on people and the planet, whether intentional or unintentional. While VC funds cannot alone address the world's social and environmental challenges, nor do all VC funds intend to allocate capital towards creating positive impact, all investors must at a minimum ensure they and their investee companies manage toward *sustainability*.

- **Responds to critical macroeconomic growth and business drivers.** Globally increasing demand for food, water, and energy are driving the need for innovative improvements to infrastructure to address this demand for resources. Drinking water and sanitation, innovations in generating and distributing energy, improved health care, and more efficient transportation provide an abundance of opportunities for sustainable investment growth.

- **Increasingly demanded by consumers, a trend expected to continue.** Millennials are incorporating *sustainability* into not only their purchase decisions but also their investment decisions. In such a context, companies committed to *sustainability* present an investment opportunity.

- **Demanded by investors and asset owners.** More and more LPs integrate *sustainability* into their screening and selection of GPs. In 2018, over 70% of institutional investors integrated ESG considerations into the selection and management of their investments[4]. Moreover, as investments in the critical infrastructure areas described above continue to show a strong financial track record, investors will demand companies that not only perform but also align with their values.

- **Improves operational excellence.** Integrating *sustainability* topics can help improve operations for a VC-backed company. For example, good HR practices can help attract and retain talent, while diversity in a senior management team or at the board level is correlated with

4. Susan Winterberg, Laura Manley, Karen Ejiofor, Amritha Jayanti, Joseph Fridman, Sam Lambert, and Marta Zwierz, Responsible Investing in Tech and Venture Capital: Advancing Public Purpose in Frontier Technology Companies (Cambridge, MA: Belfer Center for Science and International Affairs, Harvard Kennedy School, August 2020), https://www.belfercenter.org/publication/responsible-investing-tech-and-venture-capital.

higher financial returns for public companies, McKinsey reports[5]. Companies that proactively manage their relationships with various stakeholders can also better understand and anticipate the needs of their customers.

- **Better done early than late.** As some of the first investors in companies, VC funds can shape and influence companies' strategies and culture. While at the time of initial VC investment a company may be small and early-stage such that some *sustainability* factors may appear "irrelevant," successful, fast-growing companies can quickly face significant issues around *sustainability*. WeWork, for example, had to cancel its IPO and lost half its valuation after its financial and governance challenges were revealed[6].

State of practice

VC fund managers often describe themselves as lagging other asset classes in incorporating *sustainability* practices consistently across their practices and processes, for varied reasons:

- Existing responsible investment standards and principles are not tailored to the specific needs and challenges of VC funds.

"I can't ask 20 detailed questions about HR policies to a new startup. What exists applies to large corporates, but not to startups."-*(VC fund manager)*

- A dynamic but inconsistent understanding of what *sustainability* management means across geographies and sectors leaves VCs often hesitant to act.

- Historically, VC funds have lean teams, often lacking the in-house skills and capabilities or the resources needed to hire an outside expert to get started with *sustainability*.

"Dedicating a resource means pulling it from another value-adding activity, such as fundraising."-*(VC fund manager)*

- Fund managers express a common concern that additional diligence requirements for a potential investee may translate lost deals when competing with traditional investors.

"I think people in general understand the value of it, but if they're about to lose a deal, they'll compromise the weight they give to sustainability information requests."-*(VC fund manager)*

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5. Sundiatu Dixon-Fyle, Kevin Dolan, Vivian Hunt, and Sara Prince, Diversity Wins: How Inclusion Matters (London: McKinsey & Company, May 2020), https://www.mckinsey.com/featured-insights/diversity-and-inclusion/diversity-wins-how-inclusion-matters.

6. Susan Winterberg, Laura Manley, Karen Ejiofor, Amritha Jayanti, Joseph Fridman, Sam Lambert, and Marta Zwierz, Responsible Investing in Tech and Venture Capital: Advancing Public Purpose in Frontier Technology Companies (Cambridge, MA: Belfer Center for Science and International Affairs, Harvard Kennedy School, August 2020), https://www.belfercenter.org/publication/responsible-investing-tech-and-venture-capital.

Box 1: What is SFDR, and how does it relate to managing *sustainability*?

The EU Sustainable Finance Disclosure Regulation (SFDR) requires participants in financial markets and financial advisers to report how they account for *sustainability* risks. SFDR addresses the same need as does *sustainability* management: to take **environmental and social** considerations into account when making investment decisions in order to make investment activities more sustainable over the long term. The intent is to regulate the financial sector so that financial actors take the necessary measures to preserve stability and **limit possible harm to people and the planet.**

SFDR is part of a broader EU legislative package, the Sustainable Finance Action Plan, that aims to promote sustainable investments and the transition to an inclusive, low-carbon, and resource-efficient economy. With this legislation, the EU intends to use the financial sector to build and finance a sustainable economy through a series of regulations:

-The EU Taxonomy regulation, which defines criteria for determining whether investments are considered sustainable based on environmental, social, and governance factors.

-The Non-Financial Reporting Directive (NFRD), which requires companies to disclose non-financial information.

The SFDR establishes specific rules regarding how and what information related to *sustainability* EU financial market participants (FMP) must disclose. The SFDR aims to ensure that market participants can finance growth sustainably over the long term by increasing the flows of funds to sustainable investments and enabling greater transparency.

To that end, the SFDR incorporates the concept of **Principal Adverse Impacts (PAIs):** the potential negative impacts on people and the planet resulting from an investment decision. PAIs involve four *sustainability* factors: **(a) environmental matters, (b) social and employee matters, (c) respect for human rights, and (d) anti-corruption and bribery matters.**

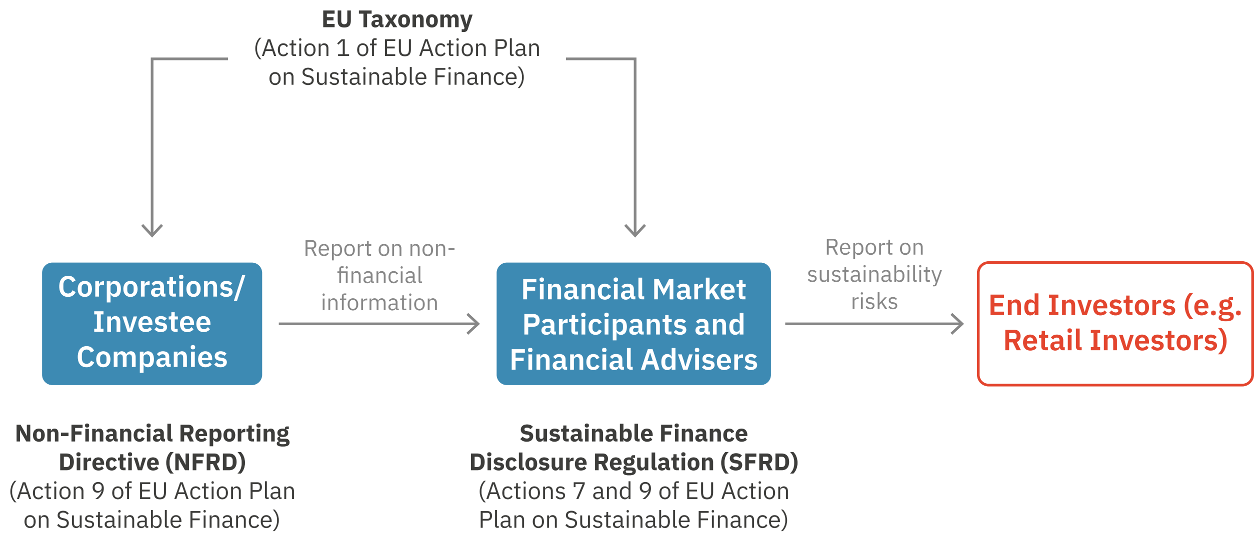
What should be disclosed according to the SFDR?

SFDR requires disclosure of information concerning:

- business model, policies (including due diligence processes), and results;
- risk management ([LE1], including risks related to business relationships); and
- KPIs related to the four identified *sustainability* factors.

Sustainability impacts must be **identified and disclosed at both the entity and product levels** (see Figure 2 below).

Figure 2. SFDR Disclosure Requirements: Entity and Product Levels



Source: Andreas Rasche

Implementing sustainability management

By embedding *sustainability* practices into the way funds are managed, investors can make better decisions that achieve targeted financial returns while minimizing the risk of negative environmental and social impacts. Such an approach goes beyond metrics and reporting by including considerations of *sustainability* in decision-making and day-to-day practices. To do so, funds need defined *sustainability* objectives and strategy, policies and practices, and governance to deliver on the defined objectives.

The playbook begins with a quick self-assessment for VC funds to map their current state of practice. It then proceeds with a step-by-step guide for funds to integrate *sustainability* into their fund management.

Getting Started

Though implementing the consistent management of *sustainability* can seem daunting, most VC funds already have some level of practice in place. The checklist below comprises components of effective *sustainability* management, offering three different levels of practice:

- **Beginner practice:** for those with no current practice, ways to get started.

- **Medium practice:** for those with some level of practice, ways to identify potential gaps, where they should aim for the future, and what to consider to get there.

- **Advanced practice:** for those with substantial existing practice, how to refine that approach and focus on continuous improvement.

Implementing consistent, high-quality *sustainability* management is a process and a journey that will not happen overnight. VC funds should aim to start from where they are and grow their practice over time.

Sustainability **Checklist**

This checklist can help VC funds quickly assess their own state of practice to identify both areas of strength and opportunities for improvement.

1. The VC Fund has committed to and endorsed sustainability principles covered by Global conventions (e.g. the UN Guiding Principles on Business and Human Rights, The UN Women's Empowerment Principles, The ILO's Eight Fundamental Conventions for Labour Standards, Office of the United Nations High Commissioner for Human Rights' Free and Prior Informed Consent for Indigenous Peoples, the objective of the Paris Agreement on Climate Change).

   a. **Advanced practice:** The fund is committed to all or most of the principles.

   b. **Medium practice:** The fund is committed to at least one of the principles.

   c. **Beginner practice:** The fund has not yet committed to any of these principles.

2. The VC fund has *sustainability* purpose and goals aligned with its strategy and funding sources.

   a. **Advanced practice:** The fund has a clear, explicit *sustainability* objective (or purpose) and goals which are developed in partnership with senior management and clearly communicated to all employees. The goals are measurable and time bound (e.g., all investments align to specific diversity or *sustainability* targets). All funding comes from investors who are aligned with a *sustainability* approach. Examples of possible purposes and objectives include: eliminate child labor in the supply chain by 2025, become carbon-neutral in products and operations by 2040, or increase the talent pipeline for young women in software engineering by 20%.

   b. **Medium practice:** The fund has no specific *sustainability* goals but follows a *sustainability* approach in its decision-making and operational practices (such as a specific *sustainability* questionnaire during due diligence or exclusion lists). Some funding may come from investors who are aligned with a *sustainability* approach.

   c. **Beginner practice:** The fund has no *sustainability* goals or comprehensive approaches in place but does incorporate some *sustainability* practices (such as exclusion lists). Funding sources do not yet require alignment to *sustainability* goals.

3. The VC fund has policies and practices related to *sustainability*.

   a. **Advanced practice:** *Sustainability* policies and practices are implemented consistently across all investments and across the entire investment lifecycle (screening, due diligence, ongoing monitoring, and exit). The fund has effective policies (for an example, see ALIVE Venture's responsible investment policy), mechanisms, and processes to deliver on its goals, including its *sustainability* investment thesis and portfolio-level goals. As one example, specific *sustainability* questions are integrated into the due diligence questionnaire used with all potential investees, serving to flag material risks that could create harm.

b. Medium practice: The fund has some *sustainability* policies, mechanisms, and practices in place to facilitate investment in companies that act to avoid harm. However, these may not be applied consistently to all investments or they may still be under development.

c. Beginner practice: The fund has no specific policies, mechanisms, and processes related to *sustainability* and just refers to internationally accepted exclusion lists.

4. The VC fund incorporates *sustainability* throughout the investment process.

a. Advanced practice: *Sustainability* is incorporated across the investment lifecycle: strategy and goal setting, screening and due diligence, ongoing management, and exit.

b. Medium practice: *Sustainability* is incorporated in some but not all stages of the investment process but the fund has ongoing management of *sustainability*, as well as reporting at least yearly.

c. Beginner practice: *Sustainability* is only incorporated as a screening tool (such as a checklist or screening during due diligence).

5. The VC fund has or develops internal skills and capabilities related to *sustainability*.

a. Advanced practice: All employees (including management) clearly grasp the importance of *sustainability*, which is fully integrated into fund processes, from venture screening to portfolio management. A dedicated team member or external partner provides the fund with deeper *sustainability* expertise. The fund undergoes external review and verification of its *sustainability* practices.

b. Medium practice: While the fund has no *sustainability* expert, most employees (including management) understand the value of *sustainability*.

c. Beginner practice: Management does not yet buy into the value of managing *sustainability*. One team member understands *sustainability* practices and is the default person in charge of that work.

6. The VC fund has set specific KPIs to measure and report on *sustainability* matters.

a. Advanced practice: The fund uses a set of standardized indicators aligned with LP requirements and international standards, where applicable (e.g., GRI, SASB), to comprehensively measure and manage the *sustainability* of all investments. The fund reports these externally on an annual basis.

b. Medium practice: The fund measures and reports only on those KPIs LPs require.

c. Beginner practice: The fund collects *sustainability* data only during screening or due diligence, not on an ongoing basis. As a result, the fund cannot report *sustainability* data.

7. The VC fund transparently discloses how it integrates *sustainability* into its purpose, strategy, management, governance, and decision making, reporting (at least annually) on its performance.

a. Advanced practice: The fund publicly discloses its non-financial performance at least annually in an easily accessible (e.g., on its website), clear, and transparent form.

b. Medium practice: The fund discloses some details of its non-financial performance but not regularly and mostly when requested (e.g., by LPs).

c. Beginner practice: The fund cannot yet formally report its non-financial performance but intends to do so within the next 12 months.

8. The VC fund aligns with globally recognized *sustainability* standards, principles, frameworks, and tools, thus ensuring alignment with best practices.

a. Advanced practice: The fund aligns its activities with global frameworks (e.g., the UN SDGs) or principles (e.g., the UN PRI), integrates tools and resources into its investment practice (e.g., the IFC exclusion list, IRIS+/IRIS metrics), and reports according to accepted reporting standards (e.g., GRI, SASB, IFC standards) tailored to the fund's specific needs.

b. Medium practice: The fund has begun to align to some global frameworks (e.g., SDGs) and adheres to LP's requests and checklists regarding what to measure and when, as well as how to report.

c. Beginner practice: The fund leverages global tools, but only during due diligence or screening (e.g., the IFC exclusion list).

9. The fund's commitment to *sustainability* is reinforced through the governance practices of the fund and fund manager.

a. Advanced practice: The fund has active oversight from its governing bodies regarding its *sustainability* strategy, policies, processes, performance, and disclosure practices. Its governing body has the required competencies in *sustainability* and is committed to diversity. The fund meets minimum national governance standards, as appropriate. The governing body holds GP(s) accountable for managing the fund for *sustainability*.

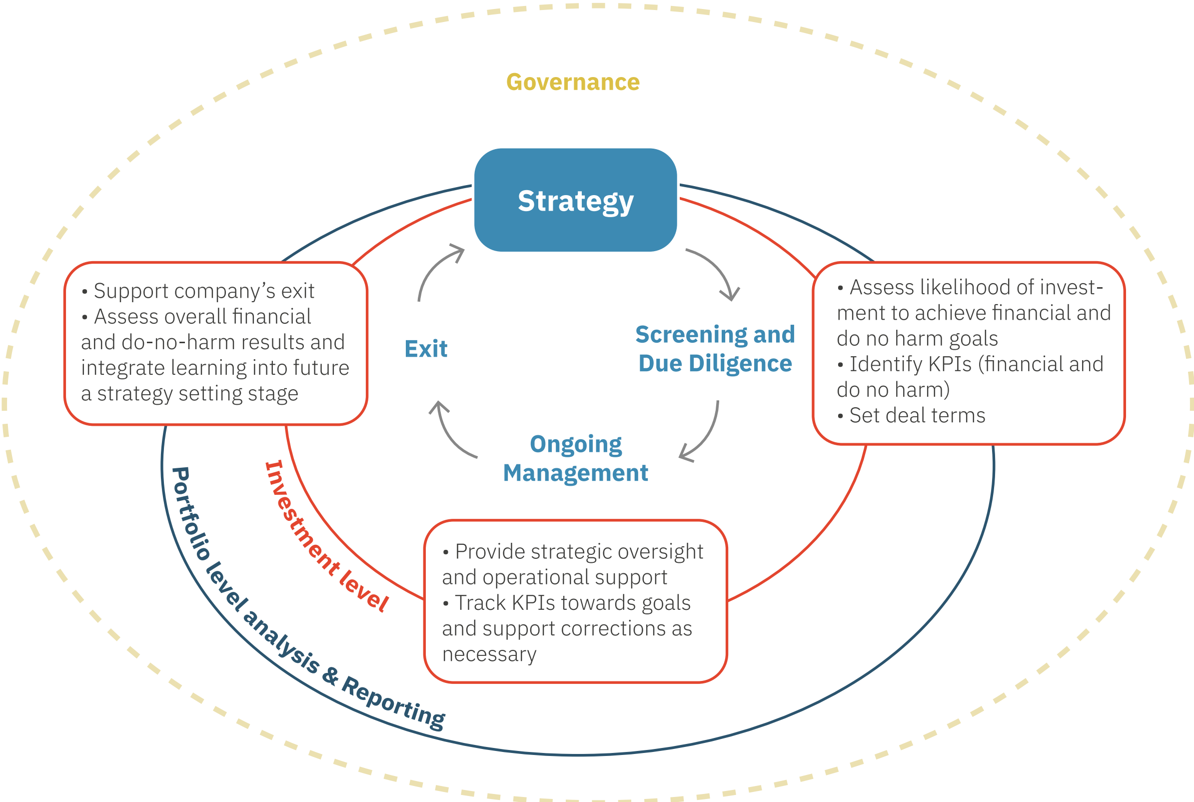
b. Medium practice: The fund has some oversight from its governing bodies regarding its *sustainability* strategy, policies, processes, performance, and disclosure practices. Its governing body is committed to diversity. The fund meets minimum national governance standards, as appropriate.

c. Beginner practice: The fund has no oversight from its governing bodies regarding its *sustainability* strategy, policies, processes, performance, or disclosure practices. The fund meets minimum national governance standards, as appropriate.

Integrating sustainability management

This section presents a step-by-step guide for how VC funds can integrate or advance *sustainability* into their management practices. To that end, the VC fund management cycle is modeled in six steps (Figure 3): (a) Strategy (and Governance); (b) Screening and Due Diligence; (c) Ongoing Management; (d) Exit, (e) Portfolio Analysis; and (f) Reporting.

Figure 3: Key Steps in the Fund Management Cycle



Achieving *sustainability* requires that related goals be included in a fund's strategy, which should outline the fund's purpose, goals, and how the desired change will be achieved. With that strategy in place, the fund should next establish policies, processes, and practices to maximize the chances of achieving its goals across due diligence, ongoing management, and exit. Importantly, this is an ongoing cycle; learnings feed back into strategy, thus enabling continuous improvement. In that context, reporting and disclosure can facilitate understanding, learning, and the identification of opportunities for improvement, and reporting should not be limited just to performance but also cover management practice and how decisions are made. Finally, governance "holds" the system together by setting incentives and reinforcing the fund's commitment to its *sustainability* goals.

At the level of fund management, *sustainability* considerations can be embedded into decision-making and practices across the fund, which aligns with the SDG Impact Standards for Private Equity Funds, a resource which this section has leveraged as key reference.

1. During Strategy

Including specific intentions about *sustainability* in fund strategy not only strengthens credibility about the fund's commitment to *sustainability* but also allows managers to define a plan to reach *sustainability*-related goals and share them with the organization. Having a clear responsible investment policy, investment thesis, and *sustainability* strategy can also help General Partners (GPs) in fundraising, as Limited Partners (LPs) are increasingly looking for GPs that align with their values and policies. Since VC is a higher-risk asset class, aligning with LPs' values can help VC funds differentiate. While today *sustainability* may present a competitive advantage, in the medium-term, managing *sustainability* is very likely to be required by all LPs. (VCs may as well get ahead now!).

Defining fund strategy around *sustainability* comprises four main steps ("business actions"):

1. Embed *sustainability* goals and considerations into the fund's purpose.

2. Develop an investment thesis (or theory of change)[8].

3. Set portfolio-level *sustainability* goals.

4. Adjust the thesis, investment strategy, and portfolio-level *sustainability* goals as needed to optimize results.

1. Embed *Sustainability* Goals into the Fund's Purpose[8]

Responsible VCs respect human rights and planetary boundaries, among other responsible business practices, which can be reflected in their commitment and/or endorsement of the following standards, principles, and initiatives:

7. The SDG Impact Standards refer to an "impact thesis," which in this case would specifically be seen through the lens of avoiding and reducing negative impacts or "doing no harm."

8. For detailed guidance on this step, see the SDG Impact Standards for PE (1.1.1).

- UN Guiding Principles on Business and Human Rights
- The UN Women's Empowerment Principles
- The International Labour Organization's Eight Fundamental Conventions for Labour Standards
- Office of the United Nations High Commissioner for Human Rights, Free and Prior Informed Consent for Indigenous Peoples.

Where could a fund incorporate these commitments?

- **A public statement:** For instance, on the fund's website or by becoming a signatory to initiatives.
- **Responsible Investment Policy[9]:** A document that outlines a fund's core set of responsible investment principles and values, a Responsible Investment Policy applies to all fund investments and operations. The policy should be clear, concise, and signed by a senior partner; shared with all team members; and ideally also shared publicly (e.g., on the fund's website). Last but not least, leadership should review and update the Responsible Investment Policy on an ongoing basis, at least annually.

2. Develop an Investment Thesis

Once committed to *sustainability* goals, the fund should next establish a hypothesis for how to achieve them, ideally embedded into the investment thesis, which describes the path to change. Multi-sector funds with more than one investment thesis should complete this process for each. For example, a fund may have an investment thesis at the fund level for its overall activities plus others for each target investment sector. For detailed guidance on this step, refer to the GIIN's "A Guide for Impact Investment Fund Managers" and the SDG Impact Standards for PE (1.1.2-1.1.5).

3. Set Portfolio-Level *Sustainability* Goals

With an investment thesis in place, fund managers should set concrete goals related to preventing and reducing material negative outcomes. These goals should be measurable, with appropriate targets set given

9. Marc Williams and Konrad Huber (Environmental Resources Management), Responsible Venture Capital: Integrating Environmental and Social Approaches in Early-Stage Investing (London: CDC Group; The Hague: FMO, January 2020), https://www.fmo.nl/responsible-venture-capital.

the fund's size, existing evidence, and available data on context and thresholds. When establishing goals, targets, and timelines, it is helpful to consider unintended consequences and have mitigation plans in place for adverse scenarios. If applicable, these goals could be defined in alignment with *sustainability* topics as defined in the SASB materiality map[10].

Box 2. Tips for Setting Goals[11]

When setting goals, keep in mind that you should be able to track progress and measure results. To that end, it is helpful to define the following.

- Desired Outcome: A statement of your *sustainability* goal.
- Metrics: Indicators selected to measure that goal.
- Targets and timeline: What do you expect to achieve? By when?
- Baseline: What is the starting point or initial value, used as a reference?

Example of an outcome and outcome indicator

Outcome: Improved management of forests

Outcome indicator: **Percent change in land directly controlled under forest management-related certification (OI1120/OI5408)**

Good indicators are SMART[12]:

- **Specific:** Describe specifically what is being measured and are easy to communicate.
- **Measurable:** Quantifiable and verifiable.
- **Achievable:** Accompanied by realistic targets for change within a specific timeframe.
- **Relevant:** Help to verify whether the desired change has been achieved and useful for decision-making and analysis.
- **Time-bound:** Accompanied by a timeframe to allow tracking of progress and assessment of actual results.

VC funds should refer to existing standard indicators whenever available.

10. Although SASB focuses on financial materiality, the areas in the materiality map can be used to guide responses to the question: "What potential negative impacts might the organization be generating?" For more, see the Appendix.

11. For more details on setting goals, see the following course: Duke University and UNDP, Impact Measurement and Management for the SDGs (Coursera), https://www.coursera.org/learn/impact-for-sdgs.

12. Dawn Roberts and Nidhi Khattri, Designing a Results Framework for Achieving Results: A How-to Guide (Washington, DC: Independent Evaluation Group of The World Bank, 2012), https://documents1.worldbank.org/curated/en/331541563854787772/pdf/Designing-a-Results-Framework-for-Achieving-Results-A-How-to-Guide.pdf.

4. Adjust *Sustainability* Thesis, Investment Strategy, and Portfolio-Level *Sustainability* Goals as Needed to Optimize Results

This non-sequential step concerns the adjustment of strategy as needed based on actual results, lessons learned, or changes to context or stakeholders' preferences. The ability to adjust as needed is the core of any flexible and effective management system and increases the fund's probability of achieving its *sustainability* goals. Areas for ongoing adjustment or refinement include, for instance, the investment thesis, goals, targets or timeline, and action plans or resourcing.

Box 3. Key Considerations for Strategy

- **Understanding context.** When defining *sustainability* goals, first understand the context and potential harm and impacts that companies (investees) could have on people and planet given the particulars of each situation (for example, specifics faced in the area where a company's products are sold).

- **Engaging stakeholders.** To help prioritize among different goals, companies should engage with affected stakeholders to understand how they may experience potential negative outcomes associated with their activities.

- **Considering thresholds.** As funds define their *sustainability* objectives, they should examine outcome thresholds, meaning the level of outcome that is "good enough" according to societal goals (e.g., SDG targets) or ecological limits[13]. They can then establish targets based on such thresholds. Investors may find science-based targets a helpful resource, which provide a pathway for companies to reduce greenhouse gas (GHG) emissions. Targets are "science-based" if they align with what current science estimates is necessary to meet the goals of the Paris Agreement: limiting global warming to well below 2°C above pre-industrial levels and pursuing efforts to limit warming to 1.5°C.

- **Balancing trade-offs.** When making decisions, funds should weigh different options and assess alternatives. For example, funds should consider the risk of not achieving their *sustainability* goals and define plans to mitigate such risks.

How Should a VC Fund Reinforce Its Commitment through Governance Practices?

Responsible VC funds can reinforce their commitment to *sustainability* through good governance practices. Standard 4 of the SDG Impact Standards for PE suggests good governance practices to integrate oversight of the Fund's responsible business practices, investment strategy, thesis, portfolio-wide goals, and related practices into its governance framework, in addition to ensuring that governing bodies lead by example.

13. See UNDP Glossary of Terms, p. 9: "The outcome threshold defines the acceptable range for the outcome. Performance outside of the acceptable range is negative or unsustainable. Performance within the acceptable range is positive or sustainable. Outcome thresholds can be set locally, nationally or internationally. They should also represent the affected Stakeholder's perspective, so Stakeholder feedback can be an important way to corroborate outcome thresholds, especially when they are not well-established."

2. During Screening and Due Diligence

When sourcing potential opportunities, in early screening, and during due diligence, a VC fund should implement policies and requirements to deliver on its *sustainability* goals and strategy.

Screening

- Screen for *sustainability* exclusions in business model (e.g., presence on an exclusion list or lack of compliance with labor and human rights standards). Fund managers should look for critical risks that may affect the decision to proceed[14]. Pre-screening of potential investments should align with fund purpose, goals, and strategy[15].

- Ask a set of simple questions to determine whether the potential investee is committed to *sustainability*, including adherence to principles such as:

    - UN Guiding Principles on Business and Human Rights
    - The UN Women's Empowerment Principles
    - The International Labour Organization's Eight Fundamental Conventions for Labour Standards
    - Office of the United Nations High Commissioner for Human Rights, Free and Prior Informed Consent for Indigenous Peoples,
    - The Ten Principles of the UN Global Compact

Due Diligence and Pre-Approval

- Assess the likelihood the potential investee will seek to minimize negative impacts by, for example, requesting information from the potential investee, conducting market research (i.e., looking at publicly available information), and meeting with the company's management.

- Consider whether foreseeable changes in business model imply negative implications for *sustainability*. For example, if in the future the company may rely on gig economy workers, that may present

14. Related to Fund Action 6: Develop methodology, processes, and systems to effectively measure, monitor and manage impact, and integrate into decision-making and Practice Indicators 2.2 and 2.3. SDG Impact Standards for PE, https://sdgimpact.undp.org/assets/About-the-SDG-Impact-Standards.pdf.

15. Related to Fund Action 7: Pre-screen, select, and structure investments in line with purpose, investment strategy, impact thesis and portfolio-level impact goals and Practice Indicators 2.2 and 2.3. SDG Impact Standards for PE, https://sdgimpact.undp.org/assets/About-the-SDG-Impact-Standards.pdf.

risks both in terms of the quality of the employment/contractual relationship and in terms of lack of quality control with end clients.

- Include a specific section on the *sustainability* assessment in the memo (or deck) for the Investment Committee. A helpful tool is a "traffic light" approach, which can quickly flag areas of risk or concern regarding matters of *sustainability*, as well as strengths.

- Understand whether *sustainability* is a desired feature of the investee or a "deal-breaker."

- Information requested will be a mix of management or process data and impact or outcome data, as the presence of processes or policies can serve as a proxy when data are limited or unavailable. Likewise, having *sustainability* management practices on the investor side ensures the fund manager uses the data as input to decisions.

- Engage proactively with potential investees to align objectives, terms, and expectations[16]. The focus should be on minimizing the risk of having negative impact (prevention), mitigation of risk, or correction or remediation of *sustainability* concerns.

Box 4. What Happens When Early-Stage Companies Lack the Needed Information or Fail to Comply?

VC funds often face the challenge that the (very) early-stage companies in which they invest may not be able to comply with all international standards, best practices, and requirements at the time of investment. Additionally, their dynamic nature means that their business models might change. That makes it difficult to gather consistent data on certain *sustainability* topics, as their relevance may evolve with the business model.

To navigate this challenge:

- First, help the investee company understand the value and importance of *sustainability* management and compliance with the requirements (such as risk mitigation, including avoiding potential lawsuits, attracting other investors and a pool of talent, and retaining customers).

- Second, work with the investee company to define a realistic timeline by which the company can comply with the requirements. It is important to understand that this is a journey and will not happen overnight. The role of the VC fund is to help the investee advance in that journey. An easy entry point into *sustainability* requirements is to adopt an exclusion list, which refers to the activities or sectors in which a company will not engage, such as arms or tobacco. While this is a good first step, VC funds should proactively require data related to other topics, such as commitment to human rights.

16. Related to Fund Action 7: Pre-screen, select, and structure investments in line with purpose, investment strategy, impact thesis and portfolio-level impact goals and Practice Indicator 2.4. SDG Impact Standards for PE, https://sdgimpact.undp.org/assets/About-the-SDG-Impact-Standards.pdf.

After Approval

- Once the deal is approved, work with the investee to develop an action plan to address material risks related to *sustainability* topics, as well as areas for improvement. The action plan might include priorities for the first 100 days (e.g., ensuring that the organization has a complaint/grievance mechanism), as well as less urgent items to address after the first three months (e.g., developing an HR manual for staff). The specifics of the action plan will depend on the *sustainability* risks identified and the investee's stage, context, and sector.

- Incorporate *sustainability* requirements into the legal agreement with the investee and work with them to set specific *sustainability* KPIs to track on an ongoing basis. Such KPIs can include both those for which the organization may already track or collect data and those that the organization may be able to provide in the medium term.

- When the fund has no or limited ability to influence or request information from the investee, it should seek partnerships and work with other investors to access updated information and support the investee to reduce the risks of doing harm. In such cases, it is particularly relevant during due diligence to request information on the investee's management practices, as having a robust management system for *sustainability* increases chances of success, and the presence of such a system can serve as a proxy when access to updated information is not possible.

VC funds often wrestle with the balance between taking time to assess compliance with *sustainability* topics and the need to move fast in order to "not lose the deal," particularly for deals with strong competition.

To navigate this challenge:

- Talk with companies about the benefits of incorporating a *sustainability* approach, such as attracting talent and reducing operational risks. (For further details, refer to the section, "Talking with Your Portfolio Companies about *Sustainability* approach?" on pp. 36–37).

- Be pragmatic in initial due diligence but emphasize the need for a clear roadmap for improvement or action plan after due diligence.

- Work with other investors to align on *sustainability* requirements from investees, a win-win for investors and companies. When most or all investors have the same, shared requirements, the reporting burden on companies is reduced and the availability and quality of data received improves.

- Some funds opt to conduct initial due diligence based on their own understanding and send only the most important requests for information to potential investees, leaving at-length due diligence for after the investment decision is made. To avoid significant, deal-breaking surprises, these funds include clauses in the legal agreement covering any significant issues that were not uncovered during due diligence. Funds opting for this approach must balance the benefits of their ability to move faster with the deal against the potential risks of uncovering significant issues after commitment.

- Lack of compliance with non-material *sustainability* topics may be mitigated with the understanding that the fund manager and investee will develop an action plan to increase compliance at a realistic term and pace.

- To define what information is relevant to request, funds should consider: would this additional information change the decision to invest?

3. During Ongoing Investment Management

VC funds can play an active role in their investee companies. Taking a board seat in the company is one relatively common role VCs play, depending on the equity stake and timing of investment (as earlier investors may have closer relationships with founders). With or without a board seat, VC funds can engage in ongoing management with an effective assessment and monitoring system[17]. To ensure the maintenance of *sustainability* after due diligence and during a company's ongoing operations and growth, VC funds should:

- Engage with the investee to oversee the implementation of the 100-day action plan and to address any other *sustainability* issues that may emerge as the company grows.

- Monitor and review *sustainability* data at least yearly[18]. VC funds should collect data from investees aligned to the KPIs set before

17. Related to Fund Action 7: Pre-screen, select, and structure investments in line with purpose, investment strategy, impact thesis and portfolio-level impact goals and Practice Indicatorrs 2.5 and 2.6. SDG Impact Standards for PE, https://sdgimpact.undp.org/assets/About-the-SDG-Impact-Standards.pdf.

18. Related to Fund Action 8: Monitor and manage the impact performance of each investment and for the Fund overall, acting to optimize and sustain impact, including after exit and Practice Indicators 2.3 and 2.5. SDG Impact Standards for PE, https://sdgimpact.undp.org/assets/About-the-SDG-Impact-Standards.pdf.

investment, as well as data related to other KPIs that emerge as valuable over time. Alignment with standardized KPIs where available (e.g., SASB, IRIS+) can help reduce companies' reporting burden.

- Support investees to implement good monitoring mechanisms that **increase transparency and accountability.** This could take the form of part of the company's annual report (for more mature companies), a specific *sustainability* report, or even just statistics on their website and other public-facing materials. VC funds can help investees see the value of a transparent *sustainability* approach in terms of their ability **to attract new funding and earn their customers' trust.**

    - Responsible investment has become mainstream in the last decade, and more and more investors increasingly demand responsible practice from potential investees.

    - At the same time, consumers are increasingly asking about the business practices of companies they buy from and engage with (e.g., whether they follow fair trade regulations, how they treat the environment, and how they treat their own workforce). According to recent research, 75% of Millennials say they factor in a company's values when making purchasing decisions, and a similar percentage consider a company's values when deciding where they will work[19]. Additionally, 80% of consumers who responded to a 2019 survey mentioned greater willingness to pay if a brand raised prices to be more environmentally and socially responsible or to pay higher salaries to employees[20].

- Support the company to implement *sustainability* best practices (which can also improve business performance), where VC funds can play an important role by leveraging their experience from other investments. For example, a fund might help an investee company set up risk management and responsible sourcing policies or compliance with decent job standards to ensure fair treatment of employees. This may take longer to execute for funds in the early stages of incorporating *sustainability* management, but they can still begin conversations with investees to ensure alignment in their vision and recognition of the importance of managing *sustainability*. As such funds progress along their own *sustainability* journey, they can then share their learnings with investees.

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19. Susan Winterberg, Laura Manley, Karen Ejiofor, Amritha Jayanti, Joseph Fridman, Sam Lambert, and Marta Zwierz, Responsible Investing in Tech and Venture Capital: Advancing Public Purpose in Frontier Technology Companies (Cambridge, MA: Belfer Center for Science and International Affairs, Harvard Kennedy School, August 2020), https://www.belfercenter.org/publication/responsible-investing-tech-and-venture-capital.

20. Diana O'Brien, Andy Main, Suzanne Kounkel, and Anthony R. Stephan, "Purpose Is Everything: How brands that Authentically Lead with Purpose Are Changing the Nature of Business Today," Deloitte Insights, October 15, 2019, https://www2.deloitte.com/us/en/insights/topics/marketing-and-sales-operations/global-marketing-trends/2020/purpose-driven-companies.html.

Box 5. VC Funds May Need to Manage Conflicts Over** Sustainability **at the Board Level

For example, interests may not align among different investors, the company may significantly deviate from its mission or vision at the time of the investment, or ownership and voting power may be diluted through additional investment rounds.

To navigate this challenge:

- "Hardwire" non-negotiable *sustainability* issues into investment terms.

- Set board-level policies on corporate social responsibility and risk management.

- During due diligence, ask the company about their screening and vetting of potential investors. For example, does the company look for investors that are aligned on *sustainability*?

Companies also often face different data requests from different investors, which can make compliance with those requests an overwhelming challenge.

To navigate this challenge:

- When identifying KPIs, work with your investee to identify what data they already track. For any KPIs you need that the company is not yet gathering, take two important steps:

    - Clearly explain the value of collecting that data for the investee (for example, the above reasons related to potential funding and earning consumer trust). Work with the company to help them integrate the data into decision-making, whether related to risk prevention and mitigation or to the uncovering of new business opportunities, so that gathering that data is not just seen as a compliance exercise.

    - Identify existing standardized KPIs (e.g., from globally recognized standards such as GRI, SASB, or IRIS+). That will help avoid additional reporting burdens if another investor requires a similar data point from the company in the future (e.g., on human rights or worker conditions).

    - Work with other investors to harmonize reporting requirements from investees. For a good example of this, see ALINUS (ALigning INvestors due-diligence and reporting with the Universal Standards) in Financial Inclusion, where investors have agreed to common data requirements for due diligence. Another example is IRIS+, work by the GIIN in which investors and enterprises have worked together to agree to what is included in Core Metrics Sets by sector.

4. During Exit

Exits may take the form of a buyout or acquisition or even an Initial Public Offering (IPO). Exit presents a crucial opportunity for an investee to demonstrate *sustainability* management, as lack of such an approach could affect investee valuation. In plenty of recent examples, companies' valuations dropped significantly within days after an IPO once governance challenges were uncovered. If an investee has not yet incorporated good *sustainability* management, the exit stage is too late to do so. On the other hand, for those companies that have adopted robust *sustainability* management, exit should present fewer surprises. During exit, VC funds can take several steps:

- Evaluate the progress of the investee's *sustainability* management over the life of the investment, including not just the implementation of the 100-day action plan but also how the organization continued to adopt and adjust its practices and policies.

- Support the investee to demonstrate to potential buyers opportunities identified through their *sustainability* management, as well as any risks mitigated, to give potential buyers peace of mind that the company has engaged in responsible, thoughtful behavior and that new buyers would therefore not be acquiring potential future litigation risks.

- Assess the *sustainability* and reputational risks associated with the exit strategy. Consider, for example, whether a potential buyer with a lucrative offer might present significant reputational risks.

- Help the investee navigate through the exit, including assessing different exit types and offers.

- Capture results and lessons learned and use these as inputs for decision-making in order to improve the fund's overall practice and performance[21].

21. Related to Fund Action 8: Monitor and manage the impact performance of each investment and for the Fund overall, acting to optimize and sustain impact, including after exit, and Practice Indicator 2.3.10. SDG Impact Standards for PE, https://sdgimpact.undp.org/assets/About-the-SDG-Impact-Standards.pdf.

__Box 6. Adjusting Your Approach by Asset Class and Investment Size__

A VC fund's specific approach and influence on investees will largely depend on the asset class of investment (with equity offering more control than debt), as well as the size of investment. (Particularly in equity, those with smaller tickets or entering in later rounds have less influence than those holding significant stakes or with representation at the board level).

What can a VC fund do if its control is not significant enough to be heard?

Equity holders:

- Before entering the deal, assess the existing investors involved. Do they also value and support *sustainability*? Be wary of entering a deal with investors that do not prioritize responsible investment practices and have a majority stake in the company.

- During investment, engage with existing investors to unify your voice. Trade associations and networks are a good channel to help unify and harmonize *sustainability* practices.

Debt holders:

- Work with other investors to identify a practical and common set of *sustainability* covenants that investors agree to use in their loans to the enterprise. For example, in 2014, a group of social investors in microfinance agreed to what they considered "reasonable covenants," collaborating on practical guidelines for lenders in support of responsible microfinance. Similarly, VC funds could agree to reasonable *sustainability* covenants to include in their loans. Through collective action, even with a smaller loan amount or less "control" over the enterprise as a debt holder, common covenants provide a good way to ensure *sustainability* management is embedded and maintained throughout the investment lifecycle, including exit.

5. How to Manage the Portfolio

Based on the information collected for each investee, funds can compare investments and analyze information across a portfolio, tracking and managing individual investments in terms of their contribution to financial and impact targets for the overall portfolio and fund.

Implementing such a portfolio approach has various benefits:

- Aggregate and view results at the portfolio level and by portfolio sub-groups.

- If using a scoring or rating, help assess the expected and actual effects of each investment and the portfolio, enabling fund managers to consider target financial and non-financial returns, as well as their *sustainability* risk appetite (in other words, stakeholders' tolerance for negative economic, social, and/or environmental impacts)[22].

- Analyze alignment to fund objectives and thesis as the portfolio evolves.

- Potentially integrate impact and financial return into decision-making.

- Manage and balance financial and non-financial returns.

- Systematically assess new deals against minimum thresholds and expected individual contribution to overall portfolio performance.

In general, *sustainability* management practices should be reviewed and improved over time based on actual performance, lessons learned, and changes in context[23].

6. How to Report Transparently

Reporting, whether internal or external, should provide relevant, timely, and robust information to those making decisions and to other stakeholders.

Internal reporting should ensure information reaches those making decisions inside the organization in a timely manner, including lessons learned and risk analysis. These data can be presented for individual investees and/or for the portfolio, depending on the type of decision to support at that time. Ideally, funds should not create parallel or additional reporting layers for *sustainability* matters, instead incorporating a *sustainability* lens into existing reporting practices.

External reporting should disclose relevant information for stakeholders outside the organization, such as shareholders or policymakers. External reports should combine both performance (results) and the practices and processes that reflect how the fund **"integrates *sustainability* into purpose, strategy, management approach and governance, and reporting on performance."**

22. Orlando Ferreira, Alessandro Maffioli, and Norah Sullivan, Managing a Portfolio for Impact: IDB Invest's Impact Management Framework (Washington, DC: IDB Invest, July 2020), https://idbinvest.org/en/publications/idb-invests-impact-management-framework-managing-portfolio-impact.

23. Related to Fund Action 9: Embed continuous improvement, updating investment and impact management practices as needed, and share lessons with investees and partners, Practice Indicators 2.3, 2.5, and 2.6. SDG Impact Standards for PE, https://sdgimpact.undp.org/assets/About-the-SDG-Impact-Standards.pdf.

24. Standard 3: Transparency, SDG Impact Standards for PE, https://sdgimpact.undp.org/assets/SDG-Impact-Standards-for-Private-Equity-Funds-Version_1_0.pdf.

Box 7: SDG Impact Standards for Private Equity Funds

To demonstrate progress or achievement regarding transparency practices, the SDG Impact Standards suggest funds do the following:

- So that potential investees, limited partners, and other stakeholders can make informed decisions, disclose relevant information about the fund and fund manager (legal and offer documentation), including:

    - How the fund and fund manager implement and manage respect for human rights and other responsible business practices.

    - The fund's purpose and approach to long-term value creation, "impact" thesis (for this playbook, focus on *sustainability* as an impact objective), investment strategy, and portfolio-level *sustainability* objectives.

    - How a positive contribution to *sustainability* is integrated into the fund's strategy, management approach, and decision-making and reinforces the governance practices of the fund and fund manager.

- Report publicly on the fund's impact performance, including:

    - All material negative and unintended impacts at the portfolio level.

    - When feasible, all material negative and unintended material impacts at the investment level.

    - Communicate *sustainability* results, such as the reduction of negative impacts[25].

    - Disclose assumptions made, limitations of data, and impact risks and tradeoffs.

- Consider and implement the most appropriate reporting mechanisms to meet the needs of stakeholders affected by fund activities, including civil society organizations acting on stakeholders' behalf.

- Make publicly available the fund's and fund manager's policies on human rights and other responsible business practices.

25. The following ABC classification can be used to categorize contribution to impact. Impacts that do not meet these conditions are classified as "may or does cause harm."

- Act to prevent or reduce harm by moving to a less negative outcome level in relation to an appropriate outcome threshold (e.g., reducing CO_2 emissions or eliminating child labor across supply chains).

Who is responsible within a VC Fund for implementing *sustainability* managemet?

There is no single answer to this question. Some VC funds have dedicated *sustainability* professionals or contracted specialists, others entrust the responsibility to the Investment Committee or a dedicated board-level committee, and still others integrate *sustainability* management into the approach of all partners and managers.

- **Dedicated professionals:** While not yet the most common among VC funds, given their typical size, those investing in sectors with higher *sustainability* risk may want to consider bringing specialists on board full-time.

- **Member of the investment team:** Responsibility can be assigned to a single member of the investment team can ensure consistency across deals. This person should actively engage with the investee in matters of *sustainability* and just act as compliance.

- **Dedicated board-level committee:** Best implemented as additional to the other approaches here, such a committee can provide oversight on the implementation of *sustainability* matters and ensure the proper allocation of resources.

- **Outsourced to contracted specialists:** Helpful when dedicated expertise is needed that the team otherwise lacks, especially with deals in a new sector to the fund with high risk to do harm.

While allocation of responsibilities and resources will vary from fund to fund, three factors should hold regardless:

- One (or more) people must be clearly designated *sustainability* lead(s) within the fund.

- Adequate resources should be allocated, including training, dedicated time for *sustainability* matters, and economic resources, as needed.

- All internal stakeholders—including the board—should buy into the critical importance and value of adopting *sustainability* management.

• Benefit stakeholders by maintaining or improving an existing positive outcome or outcome level.

• Contribute to *sustainability* solutions or do no harm objectives by generating a new positive result: moving from a negative result to a positive one relative to an adequate threshold (e.g., provide health or education services in communities that currently lack access or provide financial services to people without access to credit or banking services).

Key sustainability factors

What sustainability factors should VC Funds assess? Investing with *sustainability* management means setting the expectation that all investee companies, regardless of their stage, type, size, or sector, should seek to and ultimately have no material negative social and environmental impacts, including in their later stages of development.

While not all companies have the explicit intention to create a positive impact in the world by solving societal challenges, all companies do have impact on people and the planet. When VC funds and their investees understand the impacts of the offered products/services and operations on people and planet, they can better leverage local knowledge, identify valuable opportunities for innovation and improvement, and better manage risk (among many other benefits).

To ensure a company does no material harm to people and the environment, VC funds should assess several key factors. While specific material factors will vary with sector and stage of development, VC funds and their companies should always assess three general factors during due diligence, ongoing monitoring, and exit: People, Planet, and Business Integrity.

Figure 4: Key dimensions and sample key factors within each to assess the companies' effects and ensure** sustainability **management.

VC funds can assess which topics within each of these dimensions are most material to their investee companies. Since all factors are interconnected, investors and investee companies could simply analyze each aspect of operations (e.g., supply chain, products, corporate operations) and assess for each the impact on People, Planet, and Business Integrity.

Which stakeholders matter?

Which factors are material

Certain sectors or industries may pose certain risks that are less relevant for others. For example, companies in healthcare or manufacturing have higher risks regarding the use, storage, and handling of chemicals and hazardous substances compared to companies in education. As a result, each VC fund, depending on their sector(s) of focus, should work to understand which factors may present significant risks. Investors often use the SASB Materiality Map to identify the most material risks by industry and topic. As a starting point, this tool identifies those issues in specific sectors that are reasonably likely to impact a company's financial condition or operating performance and are therefore most important to investors.

However, to fully understand all risks (and potential negative impacts), companies should engage with all affected stakeholders to understand and integrate their perspectives. The guiding question is: what impacts are material to them? While VC funds are one (or more) steps removed from companies' stakeholders and will often not engage directly or at least inconsistently throughout the investment lifecycle, investors should work to understand the company's stakeholders, including how the company impacts them, who the company engages with and how often in decision-making and business practice, and what is done with the input received. Good and consistent stakeholder engagement is both vital for managing impact and risk and offers a rich source of innovation. Without understanding the perspective of those affected, companies cannot fully understand or hold themselves accountable for the effects of their products or services and operations. For VC funds and investees, a helpful resource is Engaging All Affected Stakeholders, a publication led by the Social Performance Task Force (SPTF), with the input of dozens of experts and investors, under the World Economic Forum's effort to advance impact measurement and management. The document offers step-by-step guidance for engaging with stakeholders, including how to develop engagement plans (identifying the influence and frequency of engagement with each key stakeholder group), how to balance different, possibly misaligned expectations, how to source online tools for stakeholder engagement, and how to integrate the gathered data into a company's decision-making.

Understanding material impacts on stakeholders is critical for long-term performance. Indeed, understanding which ESG issues are financially material first requires a clear understanding of the impacts the organization has on people and the planet.

Talking with yout portfolio companies about sustainability management

When engaging with potential investees, fund managers can do the following:

- Understand where the companies are. What are their *sustainability* goals and practices? Are they interested in this topic?

- Direct the conversation from there. Where *sustainability* is relatively new or not yet incorporated, make the case for *sustainability* management. Support investees as needed with technical assistance or resource mobilization. Investees might generally fall into one of the following three categories:

    - **No internal buy-in to adopt** *sustainability* **management:** Link the conversation to the investee's risk-management framework. Environmental and social issues are increasingly affecting businesses and their financial performance today and in the future. Managing environmental, social, and governance issues from a risk perspective will increase company resilience and provide opportunities to develop new products and services.

    - **Interested in adopting** *sustainability* **management:** Discuss potential areas for improvement and how you can support them. Share what you have learned, your progress and your challenges as you support each other on your journey. The Appendix offers further resources you might share.

    - **Already implementing** *sustainability* **management:** Encourage the investee to share their experience in the form of case studies and blog posts or connect the investee with your broader network. International organizations or associations, and National Advisory Boards (NABs) are always looking for case studies and learning opportunities.

- Work to align reporting and data requirements to existing practices, leveraging existing social and environmental data and existing capacities for data collection and reporting.

- Build internal investee capacity to manage risks and to maximize the chances of sustainable growth.

- Help identify potential areas for improvement based on best practices, benchmarking, and analytics and share lessons learned based on their data.

- Support investees to use their environmental and social data for their own decision-making. For instance, how might these data help them make their products or operations more sustainable?

- Support investees disclose and communicate their commitment to and actual progress in operating in line with sustainable development.

Appendix

1. Most relevant factors of people, planet and bussiness integrity for VC Funds

2. SASB Materiality map

3. Ethics and technology (Technoethics): Key risks and how fAIr LAC adresses them

4. Existing approaches and tools for *sustainability* management

Appendix 1.

Most relevant factors of people, planet, and bussiness integrity for VC Funds

The factors of *sustainability* management considered relevant for VC funds and their investee companies were identified through a benchmarking exercise, which involved: (a) evaluating the state of the art in terms of existing tools and documents; (b) reviewing the identified materials, tools, and frameworks; and (c) identifying the relevant factors for VCs, following the dimensions in international standards and frameworks, specifically the International Finance Corporation (IFC) Performance Standards, Global Reporting Initiative (GRI), and the *Sustainability* Accounting Standards Board (SASB).

The IFC, GRI, and SASB dimensions and factors were considered highly relevant for VCs if they are included in at least three of the following four identified tools and references:

- Susan Winterberg, Laura Manley, Karen Ejiofor, Amritha Jayanti, Joseph Fridman, Sam Lambert, and Marta Zwierz, Responsible Investing in Tech and Venture Capital: Advancing Public Purpose in Frontier Technology Companies (Cambridge, MA: Belfer Center for Science and International Affairs, Harvard Kennedy School, August 2020), https://www.belfercenter.org/publication/responsible-investing-tech-and-venture-capital.

- Constanze Trautwein, Klaus Fichter, Claudia Tober, and Raschid Masri, Manual for the *Sustainability* Assessment of Start-ups: A Practical Tool for Start-up Teams, Investors, and Funding Organizations (Berlin: Borderstep Institute for Innovation and *Sustainability*, March 2018), https://www.borderstep.de/wp-content/uploads/2018/03/GreenUpInvest_Leitfaden_EN_RZ.pdf.

- Marc Williams and Konrad Huber (Environmental Resources Management), Responsible Venture Capital: Integrating Environmental and Social Approaches in Early-Stage Investing (London: CDC Group; The Hague: FMO, January 2020), https://www.fmo.nl/responsible-venture-capital.

- Adam Black, Phil Case, Penelope Latorre, and Adinah Shackleton, British Private Equity & Venture Capital Association (BVCA), "Responsible Investment Toolkit," https://www.bvca.co.uk/Our-Industry/ESG-and-Responsible-Investment/Responsible-Investment-Toolkit.

While some aspects of "doing no harm" apply to all VC funds and investee companies, others' degree of application depends on the specific industry or sector of operations or stage of development. Below are the generally accepted, most relevant topics for VC funds to consider under the dimensions of people, planet and business integrity.

PEOPLE. Aspects related to "people" concern how a company manages relationships with its stakeholders, including employees, suppliers, customers, and the community. Social factors are critical for VC funds and investee companies. For example, the stability of a company's supply chain will be undermined by poor labor practices and human rights violations. High worker turnover and low worker motivation and productivity can also weaken operating performance. Effective management of social factors allows companies not only to ensure a motivated, productive, and qualified workforce that creates human capital but also to earn a competitive advantage in the market and strengthen their supply chains[26]. Issues of human rights, workforce diversity, worker rights and safety, labor relations, and child labor, among others, have fundamental importance for all companies. The following are several key factors that companies and VC funds should assess with regards to understanding the company's impact on people:

- **Target Stakeholders:** To understand a company's effects on people, the first step is to define who is affected by its products or services and operations. Who are the company's target customers? Is the community also impacted by the offered products and services?What about employees, vendors, and suppliers? The second step is to understand how each stakeholder group is affected, which is best assessed by engaging directly with stakeholders and gathering their perspectives.

- **Employment/Decent Jobs:** Working conditions for employees and contractors are among the most pressing issues for VC-backed companies[27]. This includes conditions related to formal employment, "gig economy" worker status, wages paid (including reasonable equity among different genders or by seniority), and benefits, as well as whether strong HR polices are in place (not only

26. UN PRI, ESG Integration: How Are Social Issues Influencing Investment Decisions? (London: UN PRI, 2017), https://www.unpri.org/download?ac=6529.

27. Marc Williams and Konrad Huber (Environmental Resources Management), Responsible Venture Capital: Integrating Environmental and Social Approaches in Early-Stage Investing (London: CDC Group; The Hague: FMO, January 2020), https://www.fmo.nl/responsible-venture-capital.

to recruit and retain talent but also to prevent costly lawsuits around intimidation and sexual harassment). Understanding employment conditions should extend to the company's supply chain, ensuring not just the company but also its suppliers comply with local laws and regulations (e.g., no child labor is involved).

- **Community Health and Safety:** VC-backed companies should ensure their products or services and operations do not create harm for the communities they touch. For example, the company should adhere to responsible client protection practices (for those providing fintech or financial inclusion, for example, that includes fair treatment of clients, protection of data privacy, and transparency on terms and prices) and product safety policies, which should include not just direct employees and clients but also those across the supply chain.

- **Diversity and Inclusion:** A diverse and inclusive culture, workforce, and customer base provides equal opportunities and access to all stakeholder groups (e.g., women, minority and previously excluded populations, and those with disability status). Growing evidence shows that greater diversity at the company and fund manager levels benefits businesses[28]. Companies with strong ethnic and gender diversity outperform their peers as measured by return on equity and other financial metrics[29]. A diverse workforce signals an attractive work environment for talent[30]. A diverse and inclusive work environment increases employee morale, productivity, and retention. Internal best practices that go beyond legal requirements for diversity and inclusion can make a company an excellent place to work and attract consumers with social values[31]. In order to integrate diversity and inclusion at VC-backed companies, as far as possible: (a) the VC should have a non-discrimination policy; (b) diversity and inclusion goals should be established appropriate to funding stage, employee size, customer base, and core business; (c) advances in diversity and inclusion should be included in quarterly updates for investors; (d) possibilities should be expanded to entail underrepresented communities; and (v) opportunities should be facilitated for learning and expressing diversity and inclusion in order to understand what works (and what doesn't).

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28. Marc Williams and Konrad Huber (Environmental Resources Management), Responsible Venture Capital: Integrating Environmental and Social Approaches in Early-Stage Investing (London: CDC Group; The Hague: FMO, January 2020), https://www.fmo.nl/responsible-venture-capital.

29. Miriam Schwartz-Ziv, "Does the Gender of Directors Matter?," Edmond J. Safra Working Papers, No. 8, May 2, 2013, https://dx.doi.org/10.2139/ssrn.2257867; and Sundiatu Dixon-Fyle, Kevin Dolan, Vivian Hunt, and Sara Prince, Diversity Wins: How Inclusion Matters (London: McKinsey & Company, May 2020), https://www.mckinsey.com/featured-insights/diversity-and-inclusion/diversity-wins-how-inclusion-matters.

30. Stephen Turban, Dan Wu, and Letian (LT) Zhang, „When Gender Diversity Makes Firms More Productive," Harvard Business Review, February 11, 2019, https://hbr.org/2019/02/research-when-gender-diversity-makes-firms-more-productive.

31. 500 Startups, Getting Started with ESG: A Guide for Early-Stage Startups (San Francisco: 500 Startups, 2015), https://static1.squarespace.com/static/5f9c4e66c8dbce4a17de089b/t/600f7c159411b043404b57fa/1611627548385/500+ESG+for+Startups+Primer.pdf.

- **Supply Chain:** Companies' responsibility for *sustainability* increasingly encompasses not only their direct operations but also their supply chains. VC-backed companies often rely on outsourced service providers. Serious social and environmental incidents in supplier companies can significantly impact a company's reputation and value. To reduce risks related to the supply chain, VC-backed companies should consider developing a code of conduct for their suppliers that incorporate issues such as human rights, labor standards, and environmental impact. Companies should also assess the outsourced service providers and strategic partners with which they interact. Once risks are identified, the company should seek a commitment from the supplier to properly manage them and implement improvements.

PLANET. VC-backed companies can sometimes struggle to analyze their potential impact on the "planet." However, both VC-backed companies and VC funds should consider early and throughout the investment process how they can operate efficiently and without harm to the natural environment, not only for the financial benefits of efficiency in resource use but also because consumers increasingly seek to support companies and products that engage in sustainable business practices[32]. While poor management of environmental issues can lead to negative impacts, including fines and reputational damage, proactive management can realize significant cost savings through improved resource efficiency and minimized waste[33].

The specific environmental impacts associated with VC-backed firms depend on business model, sector of focus, and stage of business. The following are several key factors that companies and VC funds should assess with regards to understanding the company's impact on the planet:

- **Resource Efficiency:** Technical and economic measures can be implemented to improve efficiency in the consumption of energy, water, and other resources and material inputs as relevant to the business. Such measures can include integrating cleaner production principles into the design of products and services, improving production processes to conserve, and reducing the use of raw materials, water, and energy. Ideally, comparative analysis should establish the relative level of efficiency. Specific aspects related to the efficient use of resources may include, but are not limited to the following:

32. 500 Startups, Getting Started with ESG: A Guide for Early-Stage Startups (San Francisco: 500 Startups, 2015), https://static1.squarespace.com/static/5f9c4e66c8dbce4a17de089b/t/600f7c159411b043404b57fa/1611627548385/500+ESG+for+Startups+Primer.pdf.

33. Marc Williams and Konrad Huber (Environmental Resources Management), Responsible Venture Capital: Integrating Environmental and Social Approaches in Early-Stage Investing (London: CDC Group; The Hague: FMO, January 2020), https://www.fmo.nl/responsible-venture-capital.

(a) Energy Consumption: Contract with energy service providers using renewable sources, invest in energy-efficiency technology, implement initiatives to monitor and control energy use, reduce consumption, and improve energy efficiency. For example, day-to-day, turn off computers and equipment when not in use, use natural lighting, or opt for energy-saving light bulbs and time switches or daylight sensors in office spaces.

(b) Water Consumption: Monitor use, reduce consumption, and improve efficiency in water use. For example, invest in water-saving technologies (such as automatic or sensor faucets and efficient flush toilets), replace or fix leaky faucets, and implement more advanced techniques, such as water recirculation systems.

(c) Raw material use: Efficiency in the use of raw materials relates to the amount of material used in the manufacture of a product or provision of a service. Examples of increased efficiency include implementing practices that require the use of fewer raw materials per product or service or that generate less waste.

- **Pollution prevention:** Pollution refers to hazardous and non-hazardous chemical contaminants in solid, liquid, or gaseous phases, as well as pests, pathogens, thermal discharge to water, GHG emissions, nuisance odors, noise, vibration, radiation, and electromagnetic energy (and possible visual impacts, that is, light). "Pollution prevention" does not mean the absolute elimination of emissions but rather avoidance at the source whenever possible and otherwise the minimization of emissions to comply with existing regulations and maximum permitted limits.

Specific aspects of pollution prevention for VC-backed companies may be difficult to identify, and some companies may have little to no direct environmental impact. However, specific aspects to consider, including indirectly through supply chains, may include, but are not limited to the following:

(a) Waste management: Avoid generating waste; when it cannot be avoided, reduce the amount generated and recover and reuse the waste in a way that is safe for human health and the environment. Waste that cannot be recovered or reused should be treated, destroyed, or disposed of in an environmentally friendly manner that adequately controls emissions and waste resulting from handling and processing. Waste should be processed by reputable contractors and legitimate companies authorized by regulatory agencies and governments to manage and handle the final disposal of waste. Waste to manage may vary by sector and includes organic and hazardous waste, bio-hazardous waste, e-waste, and waste from manufacturing processes.

(b) Noise; air and water emissions: The term **emissions** describes gases and particles put into air or water by various sources[34]. **Noise pollution** is generally defined as regular exposure to elevated sound levels that may have adverse effects for humans or other living organisms. Noise pollution is so omnipresent today that we often fail to even notice it, but exposure for more than eight hours to noise beyond 85 dB may be hazardous. These forms of pollution can occur especially in the manufacturing sector.

(c) Greenhouse gases: Atmospheric concentrations of carbon dioxide and other greenhouse gases have increased since the beginning of the industrial era, and almost all of this increase is attributable to human activities. Greenhouse gas emissions from human activities have been driving observed climate change since the mid-20th century. To mitigate climate change, emissions related to human activities must be reduced or prevented. Companies and VC funds should manage business risks, opportunities, and impacts related to climate change. For any company to reduce its impact on the planet and help reduce climate change, the first step is to measure its direct and indirect greenhouse gas emissions[35]. Next, GHG emissions must be analyzed to identify the company's most-polluting activities. Companies can then consider solutions to reduce emissions from those activities.

- **Biodiversity conservation and management or use of natural resources:** Fundamental to sustainable growth are protecting and conserving **biodiversity[36]**, maintaining **ecosystem services[37,38]**, and sustainably managing living natural resources. VC-backed

34. U.S. EPA, "Air Pollution Emissions Overview," last updated June 8, 2016, https://www3.epa.gov/airquality/emissns.html.

35. Direct Emissions: Emissions from sources that are owned or controlled by the reporting company.

Indirect Emissions: Emissions that are a consequence of the activities of the reporting company but that occur at sources owned or controlled by another entity (for example, electricity consumption).

36. The UN Convention on Biodiversity defines biological diversity ("biodiversity") as "the variability among living organisms from all sources including, inter alia, terrestrial, marine and other aquatic ecosystems and the ecological complexes of which they are a part; this includes diversity within species, between species, and of ecosystems."

37. Ecosystem services are the benefits that people, including businesses, derive from ecosystems. There are four types: (a) provisioning services, which may include food, freshwater, timber, fibers, and medicinal plants; (b) regulating services, which may include surface water purification, carbon storage and sequestration, climate regulation, and protection from natural hazards; (c) cultural services, which may include natural areas that are sacred sites and areas of importance for recreation and aesthetic enjoyment; and (d) supporting services, which may include soil formation, nutrient cycling, and primary production.

38. Food and Agriculture Organization of the United Nations. n.d. Ecosystem Services & Biodiversity (ESB). [online] Available at: <https://www.fao.org/ecosystem-services-biodiversity/en/>.

companies should consider three aspects in this regard, depending their sector and main activity:

(a) Protecting forests and aquatic ecosystems: Forests and water are important natural resources that provide food, energy, and many other ecosystem services, which benefit society as a whole and the communities in which they are found[39]. To avoid possible direct or indirect negative impacts, companies that benefit from forest resources should implement proper forest management, defined as the process of planning and implementing practices for the use of forests that aim to fulfill their ecological, economic, and social relevance[40]. Aquatic ecosystems—wetlands, rivers, lakes, and coastal estuaries—are critical elements of Earth's dynamic processes and essential to human economies and health. Pressures such as land use, water abstraction, and climate change can alter the natural flow regimes of water bodies and aquatic ecosystems[41]. Companies that directly or indirectly benefit from the vital services provided by aquatic ecosystems should seek to improve the way they use and manage marine and freshwater resources[42].

(b) Biodiversity impacts: Families, communities, nations, and future generations depend on the diversity of species and ecosystems. Rising human populations have led to a dramatic and unprecedented loss of biodiversity, which means that millions face a future in which food supplies are more vulnerable to pests and disease and fresh water is patchy or scarce. Many business sectors also depend on biodiversity for the production of goods and services, and many can have adverse impacts on biodiversity through their operations, supply chains, and investment decisions. Loss of biodiversity can have direct implications for business operations and value chains, for example by increasing input costs. Business impacts on biodiversity can raise "responsible business conduct" risks for society and the environment. Depending on the sector, companies must integrate biodiversity factors into key dimensions of their business and investment decision-making, including strategy, governance, impact assessment and risk management, due diligence, disclosure, and reporting[43].

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39. United Nations Economic Commission for Europe (UNECE) and Food and Agriculture Organization (FAO), Forests and Water: Valuation and Payments for Forest Ecosystem Services (Geneva: UNECE, 2018), https://unece.org/fileadmin/DAM/timber/publications/sp-44-forests-water-web.pdf.

40. Jim Carle and Peter Holmgren, "Definitions Related to Planted Forests," in Forest Resources Assessment WP 79 (Rome: Food and Agriculture Organization of the United Nations, October 2003), http://www.fao.org/3/ae347e/AE347E02.htm.

41. National Geographic, "Aquatic Ecosystems," reference, https://www.nationalgeographic.com/environment/article/aquatic-ecosystems.

42. European Environment Agency, "Water and Marine Environment," last modified November 23, 2020, https://www.eea.europa.eu/themes/water/intro.

43. OECD, Biodiversity: Finance and the Economic and Business Case for Action, report prepared for the G7 Environment Ministers' Meeting, 5–6 May 2019 (Paris: OECD Environment Directorate, May 2019), https://www.oecd.org/env/resources/biodiversity/biodiversity-finance-and-the-economic-and-business-case-for-action.htm.

(c) Animal welfare: Animal welfare presents companies with both risks and opportunities; good animal welfare is good for business. Reduced exposure to stress and disease for animals increases productivity. Consumers also want to know that animals are treated humanely. Demonstrating best practices in animal welfare can improve market access, which is often crucial for the growth of businesses in emerging markets.

BUSINESS INTEGRITY. Business integrity refers to the values and beliefs underpinning a company's operations. Companies with strong business integrity implement corporate governance good practices; have responsible and transparent operations; comply with local (and international, when relevant) laws, regulations, and standards; manage risks appropriately; and compete fairly and openly, among other characteristics. Strong business integrity helps companies foster a culture in which misconduct and reckless risk-taking are not tolerable and which prevents, detects, and corrects serious corporate misconduct. The following are some of the key factors that companies and VC funds should assess to ensure a company's business integrity:

- **Governance:** How the company operates, including executive leadership and board, audits, and internal controls, as well as how executive compensation is determined. Good governance requires sound data management, protection of shareholders' rights, board accountability, and corporate risk management. Even though governance may not seem like a priority for a new VC-backed business, governance evolves over time with company growth and may increase in importance and complexity as a company grows and new stakeholders (or investors) join. Certain aspects and challenges can be considered from the start, such as the following:

  - Framework for board oversight: VCs-backed companies face several challenges in board structure. First, such companies tend to have smaller boards of founders and investors with fewer independent, outside directors. As a result, their directors overall have less specific expertise, including legal, regulatory, audit, risk, science & technology, and corporate social responsibility. Second, VC funds and VC-backed companies lack diversity in both investors and founders; 86% of partners at VC funds are male, and 80% of founder teams are all-male[44]. VC funds can advise portfolio companies on topics such as board composition

44. Susan Winterberg, Laura Manley, Karen Ejiofor, Amritha Jayanti, Joseph Fridman, Sam Lambert, and Marta Zwierz, Responsible Investing in Tech and Venture Capital: Advancing Public Purpose in Frontier Technology Companies (Cambridge, MA: Belfer Center for Science and International Affairs, Harvard Kennedy School, August 2020), https://www.belfercenter.org/publication/responsible-investing-tech-and-venture-capital.

and skills, structure and frequency of board meetings, and board processes to ensure the board provides sound and strategic oversight of the company's management.

  - Policies, Practices, and Codes of Expected Behavior: Early-stage companies may lack the internal policies and procedures necessary for good governance, such as human resources manuals or a code of ethics. Often, corporate cultures within VC-backed companies do not empower employees to raise safety or ethical concerns. VC funds can advise portfolio companies on initiatives to help create a culture of transparency and respect.

  - Bribery and corruption: Regulations against bribery and corruption are being rapidly developed and strengthened around the world. Anti-bribery and corruption policies help companies and VC funds avoid financial risk, attract and retain ethically minded employees, and build trust with partners, consumers, and investors. VC funds can advise portfolio companies regarding the creation of an anti-corruption code of conduct for all staff, the integrity requirements for business partners (such as suppliers and contractors), and whistleblowing policies and procedures to prevent and address retaliation.

- **Environment and Social Management System:** An environmental and social management system (ESMS) helps companies to integrate environmental and social policies and procedures so they can be consistently followed. Through ESMS, both VC-backed companies and funds can mitigate potential environmental and social risks that would otherwise reduce financial viability and identify opportunities that enhance the company's financial viability. Specific environmental and social risks vary by sector; companies with high environmental and social risk will require deeper environmental and social analysis.

- **Data Privacy and Cybersecurity:** The privacy of customer data is a key concern for customers and regulators that could present a core business issue for VC-backed companies that handle large amounts of personal information. Privacy is a fundamental human right recognized in many international and national conventions on human rights. A major cybersecurity breach can cripple a company's operations and result in a loss of customers, legal proceedings, fines, and significant reputational damage. Another type of risk in this regard concerns the perpetuation of harmful societal biases. The baseline data used by artificial intelligence (AI) may contain biases or gaps, which can lead outputs from AI to unintentionally reinforce prejudices based on, for instance, gender, ethnic, or religious grounds. Some good management practices in Data Privacy and Cybersecurity include the following:

- Transparency regarding how data are gathered, used, and secured and how data might be shared with or disclosed to others. A data privacy notice can describe these policies, with the information provided in a clear, concise, and easily accessible manner.

- Collecting as little personal data as possible and only by lawful means.

- Avoiding disclosure of personal customer information, except with clear consent.

- Directly communicating to customers any changes in data protection policies or measures.

- Considering carefully how long data needs to be held.

- Assessing input data and data-manipulation processes for possible harmful biases or inaccuracies, as well as developing mitigation measures for these shortcomings, including applying principles of Ethics in AI.

- Following basic guidance on cybersecurity at small companies and considering alignment with best practices and international standards.

Appendix 2.

SASB Materyality map

Environment

- GHG Emissions
- Air Quality
- Energy Management
- Water & Wastewater Management
- Waste & Hazardous Materials Management
- Ecological Impacts

Leadership & Governance

- Business Ethics
- Competitive Behavior
- Management of the Legal & Regulatory Environment
- Critical Incident Risk Managemente
- Systemic Risk Management

Social Capital

- Human Rights & Community Relations
- Customer Privacy
- Data Security
- Access & Affordability
- Product Quality & Safety
- Customer Welfare
- Selling Practices & Product Labeling

Human Capital

- Labor Practices
- Employee Health & Safety
- Employee Engagement, Diversity & Inclusion

Bussiness Model & Innovation

- Product Design & Lifecycle Management
- Business Model Resilience
- Supple Chain Management
- Materials Sourcing & Efficiency
- Physical Impacts of Climate Change

Source: SASB

Appendix 3.

Ethics and technology (Technoethics): Key risks and how fAIr LAC addresses them

The current socio-economic context and technological change have accelerated entrepreneurial and social innovation around the globe. The world has shifted towards an economic model that increasingly relies on data and information technology. According to the World Economic Forum, this major change in the global productivity model started in the mid-20th century and is commonly termed the Fourth Industrial Revolution. The technologies of Big Data and Artificial Intelligence are now used in virtually all industries and business models, from consumer markets to government and defense. This disruption is affecting not only how we live, eat, and move but also our jobs, human rights, the environment, and our safety and privacy.

The increasing ubiquity of these technologies has brought vast profit and improved the quality of many products and services. Nonetheless, as recent events have shown, we need to actively manage these rapid technological changes to ensure the **disruption** created will lead to better societal outcomes. It has become a challenge to make technological change positively serve humankind, a challenge that needs a new approach we all manage.

ESG and impact methodologies do not currently guide VC funds looking to invest in early-stage startups that use technology as a key component to address underdeveloped markets, scarce resources, and new business models. This keeps VC funds from planning in advance for the possible negative consequences that result from the respective technological change. Proper ethical appraisals can help businesses and VC funds understand the risks and opportunities of scaling technological products, ensuring that technology reaches its full potential with minimal friction. A wide array of principles and tools are now available to mitigate systemic bias, error, or discrimination, but few address the practical needs of entrepreneurial ecosystems.

In this regard, the fAIr LAC initiative at the Inter-American Development Bank aims to co-create several practical tools to help investors and entrepreneurs conduct these ethical appraisals to maximize economic benefit while mitigating risk. Going beyond traditional approaches focused on the data and algorithms of the technological solutions, the initiative include a multidisciplinary, strategic perspective on the development and deployment of technology and tackles three types of risk:

-Technological Risk: Risks associated with the use of technology in biometric recognition, behavioral analysis, profiling, automated or semi-automated decision making, autonomous or semi-autonomous systems, surveillance, prediction, and recommendation.

-Sector-Related Risk: Risks associated with sensitive areas such as employment, education, health, transportation, smart cities, defense, energy, and government.

-Population Risk: Risks associated with impact on historically excluded populations or those at risk of exclusion, infants, and the elderly.

To mitigate such risks, fAIr LAC co-created with investors, entrepreneurs, and experts an ethical self-assessment tool called the S3 Framework for technological solutions based on data handling and AI. The framework takes into consideration the following three main dimensions:

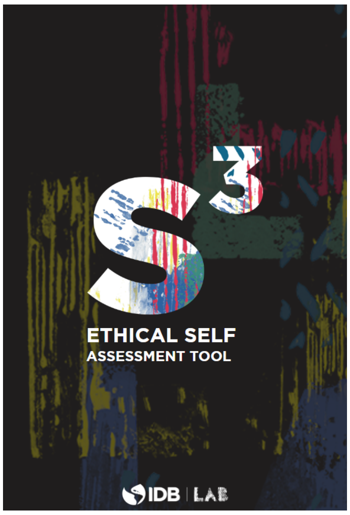
- **System:** Analyze the data and algorithmic components of the solution in order to help reduce bias and error. This dimension also helps VC funds and entrepreneurs assess the extent to which human intervention is needed, not only in critical processes but also in terms of the appropriate level of augmentation or automation for the solution. This dimension includes analysis from perspectives such as human-computer interaction (HCI), user experience and user interface (UX/UI), explainable AI (XAI), and transparency.

- **Solution:** Assess the deployment and rollout of the technological solution. This dimension provides elements for non-linear thinking and strategic foresight around the scaling of the solution in order to prevent or mitigate friction and undesired consequences. In addition to the VC fund and boards, involvement of companies' business, technical, and legal teams is relevant.

- **Society:** Examine the impact of the technological solution in vulnerable populations, which, depending on context, might include historically excluded groups or those at risk of socio-economic exclusion. Most impact assessments have traditionally focused on a very narrow understanding of the effects technology has on certain populations, unintentionally dismissing critical intersectional elements. For example, an AI system might be audited for bias against women but with almost no analysis of women from certain heritage or certain economic conditions. This dimension helps VC funds and entrepreneurs better understand these elements to mitigate the risk of bias or exclusion.

The tool and framework, developed by IDB Lab, has already been piloted in two cohorts of companies based in Brazil, Ecuador, Mexico, and Spain, and adoption has grown through partnering VC funds and acceleration programs in Brazil, Chile, Mexico, Israel, and Spain. The self-assessment tool for entrepreneurs and the risk-assessment tool for investors and VC funds share the same underlying ethical criteria, assisting in the matchmaking exercise between talent and capital.

The self-assessment tool for entrepreneurs outputs a compliance profile with a set of easy-to-implement recommendations to improve AI-based solutions from a product development perspective. For example, a health tech company in Brazil has used these recommendations to improve their algorithmic transparency by showing the relative accuracy of the AI-based system for different populations on their platform (UI). This allows physicians to see the fact that the quality of the system's predictions varies according to the data available for each population group, helping them to better calibrate their judgment when using the system. For investors, this helps reduce the risk of misguided decision-making about patient prioritization and resource allocation resulting from physicians' overconfidence in the AI system. It also contributes to the overall fairness of the system and advocates for generating more relevant and specific data for underserved populations.



The self assessment tool can be accessed at https://s3fairlac.sndbx.run

Appendix 4.

Existing approaches and tools for sustainability management

The resources reviewed in developing this playbook include the following standards, reference tools, and other resources.

- Standards:
  - International Finance Corporation (IFC) Performance Standards
  - Global Reporting Initiative (GRI)
  - *Sustainability* Accounting Standard Board (SASB)
- Reference tools and other resources:
  - Susan Winterberg, Laura Manley, Karen Ejiofor, Amritha Jayanti, Joseph Fridman, Sam Lambert, and Marta Zwierz, Responsible Investing in Tech and Venture Capital: Advancing Public Purpose in Frontier Technology Companies (Cambridge, MA: Belfer Center for Science and International Affairs, Harvard Kennedy School, August 2020).
  - Marc Williams and Konrad Huber (Environmental Resources Management), Responsible Venture Capital: Integrating Environmental and Social Approaches in Early-Stage Investing (London: CDC Group; The Hague: FMO, January 2020).
  - Adam Black, Phil Case, Penelope Latorre, and Adinah Shackleton, British Private Equity & Venture Capital Association (BVCA), "Responsible Investment Toolkit."
  - Constanze Trautwein, Klaus Fichter, Claudia Tober, and Raschid Masri, Manual for the *Sustainability* Assessment of Start-ups: A Practical Tool for Start-up Teams, Investors, and Funding Organizations (Berlin: Borderstep Institute for Innovation and *Sustainability*, March 2018).
  - 500 Startups, Getting Started with ESG: A Guide for Early-Stage Startups (San Francisco: 500 Startups, 2015)
  - PwC and ASCRI, Responsible Investment Guide for the Private Equity & Venture Capital Sector in Spain (Madrid: PwC Foundation, 2020).
  - Entrepreneurial Development Bank (FMO), "Environmental, Social and Governance Toolkit."
  - Commonwealth Development Corporation (CDC), "ESG Toolkit for Fund Managers."

Summary of Key Resources Leveraged

Responsible Investing in Tech and Venture Capital

This report reviews a range of challenges that the Venture Capital industry faces in managing ESG considerations and proposes potential solutions that the industry could adopt. It confirms that Venture Capital firms are investing in frontier technologies with potential to disrupt global security, public health, democracy, and many other areas of society.

https://www.belfercenter.org/publication/responsible-investing-tech-and-venture-capital

Responsible Venture Capital

Practice note that aims to provide advice on how to invest responsibly in early-stage businesses in emerging markets. The document, which is designed to offer practical advice for fund managers, provides a framework for VC investors to consider and manage the Environmental, Social and Governance risks and opportunities most applicable to them while supporting the growth of innovative companies.

https://www.fmo.nl/responsible-venture-capital

BVCA Responsible Investment Toolkit

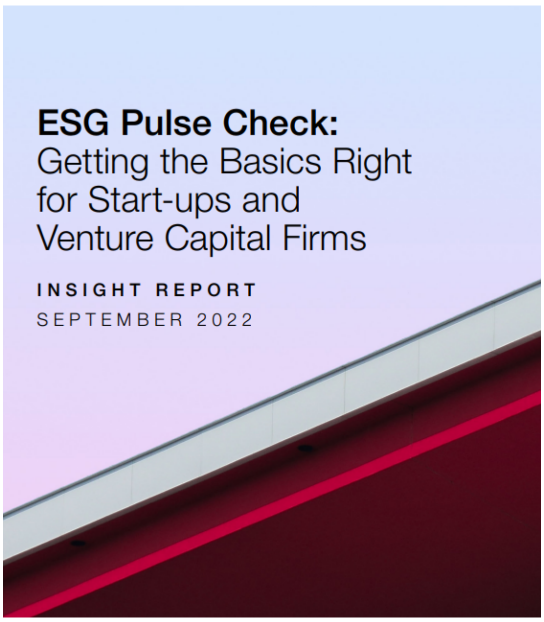
Online Responsible Investment Toolkit. As web-enabled content, the British Private Equity & Venture Capital Association (BVCA) toolkit is designed to be more accessible and easier to navigate and update as standards and practices evolve. The toolkit aims to offer practical advice throughout the investment lifecycle, from due diligence through to exit, and is accompanied by a number of case studies to demonstrate good practice. The toolkit presents the key components of a responsible investment management framework, both at a house level and throughout the deal cycle: pre-investment, during the hold period, and in the exit phase.

https://www.bvca.co.uk/Our-Industry/ESG-and-Responsible-Investment/Responsible-Investment-Toolkit

Manual for the *Sustainability* **Assessment of Start-ups**

A manual for start-up teams and ventures to intensively analyze and self-assess the *sustainability* and social impact of a business model and to communicate impact. The manual is intended to help investors identify sustainable start-ups as potential investments and competently assess these with regard to their *sustainability* and impact. Moreover, the manual is intended to drive the development of *sustainability*-oriented business models in dialogue with investors and start-ups.

https://www.borderstep.de/wp-content/uploads/2018/03/GreenUpInvest_Leitfaden_EN_RZ.pdf

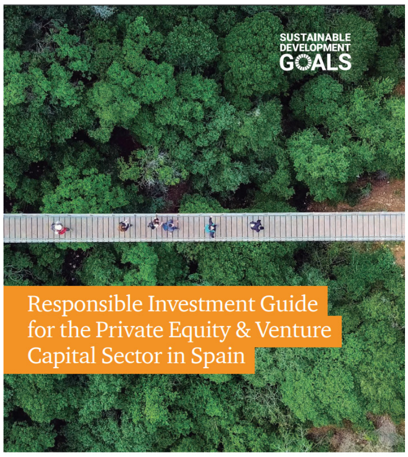


Getting Started With ESG: A Guide for Early Stage Start-Ups

This report provides succinct guidance to VC firms on implementing an ESG strategy. The main recommendations offered are: (i) integrate ESG as a corporate strategy, rather than as a stand-alone activity; (ii) adopt pragmatic and practical ESG framework that is fit for purpose; and (iii) engage with the startup ecosystem early on, to help get it done.

https://www3.weforum.org/docs/WEF_ESG_Pulse_Check_2022.pdf

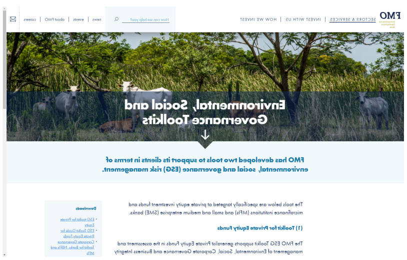
Responsible Investment Guide for the Private Equity & Venture Capital Sector in Spain



Best practices for integrating ESG criteria into management and to articulate answers to ESG challenges throughout the different activities of the private equity and venture capital sector from fundraising to divestment, including through policy development, regular reporting, or the creation of scorecards or non-financial indicators to measure the performance of entities and portfolios. Highlights several challenges faced by organizations in general and the financial sector in particular that make it essential to integrate non-financial aspects into the management and development of their activities: commitment to transparency; shareholder engagement; management of the climate crisis; the need to understand business activities as part of a global value chain; the need to evolve towards a circular economy; and the role of the private sector in achieving the SDGs.

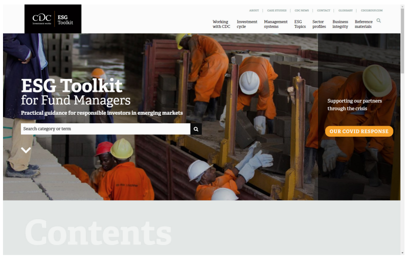
https://www.pwc.es/es/sostenibilidad/assets/responsible-investment-guide-spain-english-pwc-01.pdf

FMO Environmental, Social and Governance Toolkit



The toolkit from the Dutch entrepreneurial development bank (FMO) is specifically targeted at private equity investment funds, microfinance institutions (MFIs), and banks for small and medium-sized enterprises (SMEs). Based on various characteristics of investments, the tool overviews the most relevant ESG risks, offers a score for the effectiveness of ESG risk management, and outlines the main ESG opportunities. These three outputs are delivered at the level of both individual investments and the portfolio. For individual investments, the tool enables a structured approach to ESG due diligence and management reviews. For portfolios, the tool provides a graphical overview of the aggregated ESG situation across an entire investment fund. One specific tool concerns the assessment of Corporate Governance risks in (family-owned) enterprises during the investment phase. The toolkit is meant for enterprises in basic, emerging, and development stages.

https://www.fmo.nl/esg-toolkit

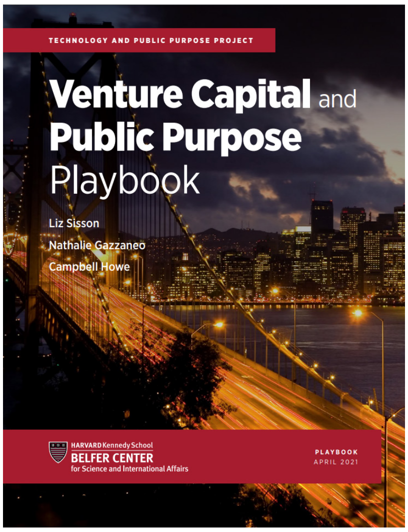


CDC ESG Toolkit for Fund Managers

A free-to-use toolkit targeted at private equity fund managers in emerging markets that aims to both practically build toward the development of a customized ESG management system and offer an easy-to-use reference guide for assessing and managing ESG risks, impacts, and opportunities.

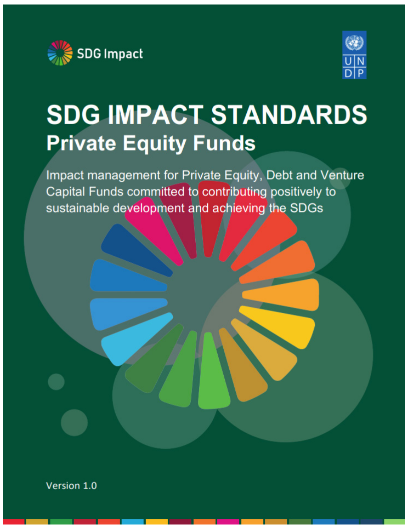
https://toolkit.bii.co.uk/

Venture Capital and Public Purpose Playbook



The Venture Capital Public Purpose Indicator and the accompanying playbook guide VCs and startups that are interested in preventing negative consequences and in laying a foundation for public purpose. Both can be used alongside other, existing diligence or planning processes.

https://www.belfercenter.org/publication/venture-capital-and-public-purpose-playbook



SDG Impact Standards for Private Equity Funds

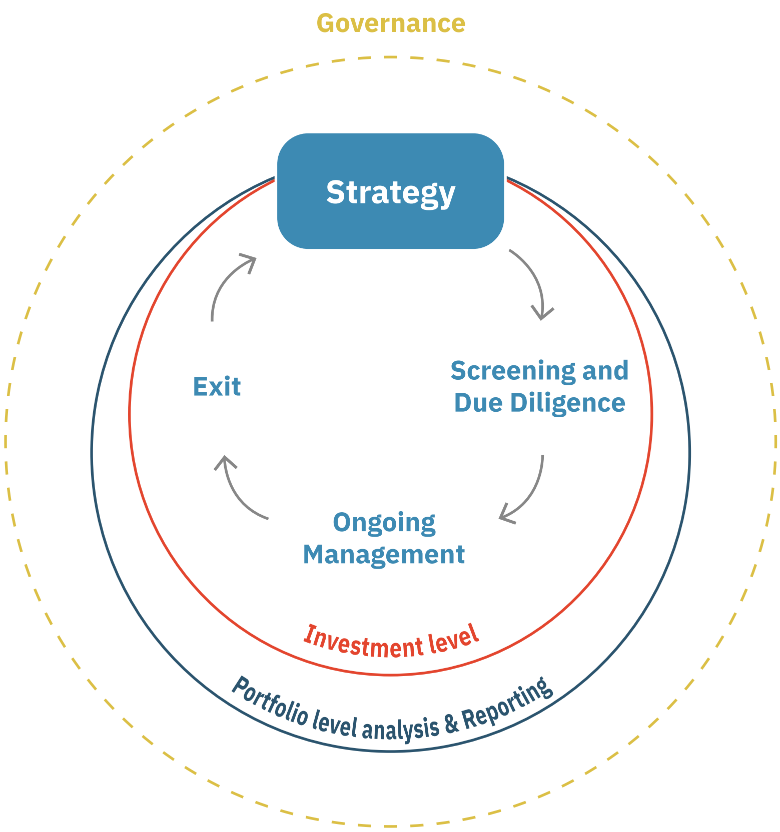
Standards for private equity, private debt, and venture capital fund managers who want to make a positive contribution to sustainable development and achieving the SDGs through one or more of their funds. The Impact Standards, provided as a public good, provide practical guidance to translate that intention into action. The standards are voluntary and freely available for all to use as best-practice standards for self-assessment. They are the first set to be released of a forthcoming harmonized suite of standards for different actors across the capital and investment spectrum.

https://sdgimpact.undp.org/assets/EN-SDG-Impact-Standards-for-Private-Equity-Funds-Version_1_0.pdf

Integrating sustainability management

This section presents a step-by-step guide for how VC funds can integrate or advance *sustainability* into their management practices. To that end, the VC fund management cycle is modeled in six steps (Figure 3): (a) Strategy (and Governance); (b) Screening and Due Diligence; (c) Ongoing Management; (d) Exit, (e) Portfolio Analysis; and (f) Reporting.

Figure 3: Key Steps in the Fund Management Cycle



Screening and Due Diligence

• Assess likelihood of investment to achieve financial and do no harm goals
• Identify KPIs (financial and do no harm)
• Set deal terms

Ongoing Management

• Provide strategic oversight and operational support
• Track KPIs towards goals and support corrections as necessary

Exit

• Support company's exit
• Assess overall financial and do-no-harm results and integrate learning into future a strategy setting stage

Achieving *sustainability* requires that related goals be included in a fund's strategy, which should outline the fund's purpose, goals, and how the desired change will be achieved. With that strategy in place, the fund should next establish policies, processes, and practices to maximize the chances of achieving its goals across due diligence, ongoing management, and exit. Importantly, this is an ongoing cycle; learnings feed back into strategy, thus enabling continuous improvement. In that context, reporting and disclosure can facilitate understanding, learning, and the identification of opportunities for improvement, and reporting should not be limited just to performance but also cover management practice and how decisions are made. Finally, governance "holds" the system together by setting incentives and reinforcing the fund's commitment to its *sustainability* goals.