Driving it forward ESG in Venture Capital *The LP perspective*

VentureESG White Paper #3

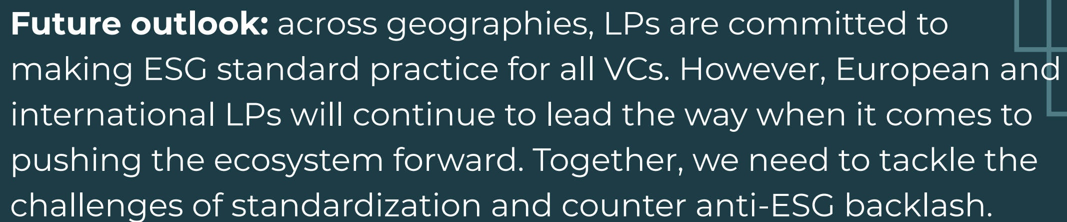
VentureESG

Executive Summary

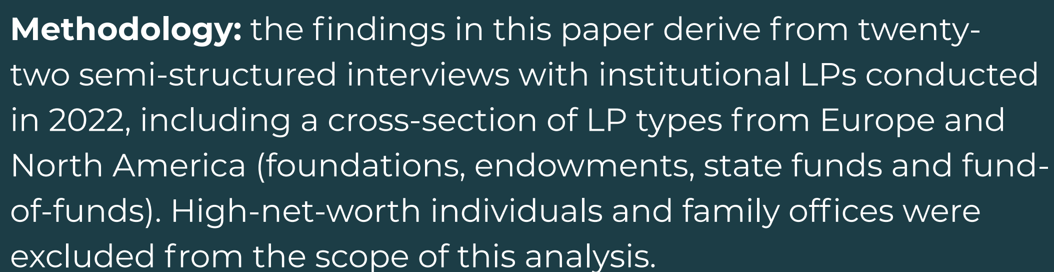
Purpose of the white paper: to understand how limited partners are approaching the integration and adoption of ESG when investing in and managing venture capital assets and how their requirements are changing.

Key observations:

1. ESG is gaining strong traction across all institutional LP types and geographies, albeit in different ways and driven by different factors. This makes VC the last asset class to comprehensively adopt ESG integration.
2. Some 'teething issues' can be identified: many common ESG frameworks are not VC-specific and an abundance of different questionnaires, approaches, and reporting metrics from LPs (on top of regulatory requirements) has brought us to the brink of an 'ESG mess', in parallel to the ESG-backlash which has been stifling public markets.
3. Positively, ESG is factored into investment decisions for the majority of LPs we interviewed while the industry is still figuring out the right requirements and engagement tactics. ESG disclosures, KPIs, and policies are mostly in focus, but ESG knowledge is growing and wider integration in funds' processes is starting to be scrutinized. Unfortunately, a small number of top US VC funds do not comply yet, leading to 'ESG exceptionalism'.
4. Across LPs, DEI data is increasingly taken seriously and collected at both VC fund and portfolio levels. With data more widely available, the push for greater gender and ethnic diversity is strongest, with different dimensions of diversity, as well as equity and inclusion, seen as next steps in VC's ESG journey.
5. Overall, LPs are confident that ESG is here to stay in VC. Navigating the lack of standardization (including in policies and overall LP expectations) and varying regulatory disclosure requirements for VC will be key factors to making ESG part of VCs' de-facto license to operate over the coming years.



Future outlook: across geographies, LPs are committed to making ESG standard practice for all VCs. However, European and international LPs will continue to lead the way when it comes to pushing the ecosystem forward. Together, we need to tackle the challenges of standardization and counter anti-ESG backlash.



Methodology: the findings in this paper derive from twenty-two semi-structured interviews with institutional LPs conducted in 2022, including a cross-section of LP types from Europe and North America (foundations, endowments, state funds and fund-of-funds). High-net-worth individuals and family offices were excluded from the scope of this analysis.

I.

How and when ESG started, for VCs and LPs

A brief history of ESG

We can date back the principles underlying ESG (environment, social, governance) to the 1980s and the rise of social responsible investing (SRI). Its development can be traced through the 1992 UN Framework Convention on Climate Change, the launch of the UN Global Compact in 2000 (and the 2004 Who Cares Wins report), and the initiation of the Principles for Responsible Investing in 2006. For investors and big corporations alike, ESG started to become common practice over a decade ago in parallel with the rise of ESG ratings. Regulation in Europe (particularly SFDR and CSRD coming into place in 2023/2024 in addition to SDR in the UK) is further cementing ESG as standard practice, at least in the form of disclosure requirements for both investors and companies, including SMEs. In the US, SEC regulation is in the making and the first fines (e.g. against Goldman Sachs and BNY Mellon) signal increased scrutiny and accountability, especially against ESG-washing.

In addition, as the business case for ESG — i.e. the positive financial contribution of strong material ESG performance of companies — becomes stronger with more available data, institutional investors and asset owners have increasingly focused on integrating ESG and offering 'ESG strategies'. From the largest asset managers, Blackrock (see Fink Letters) and Fidelity, to large endowments, foundations, and pension funds across geographies, ESG has become standard practice for investors according to Morgan Stanley's 2022 Sustainable Signals Survey. While the lack of standardization, ambiguity of ESG ratings, and a lack of system-wide regulatory enforcement are still posing question marks, for public markets ESG has already become part of a company's license to operate. Consequently, the ongoing conservative backlash against ESG in the US, while likely leading to more local state-level bans, is expected to eventually be subsumed into the overarching developments to embrace ESG as a set of non-financial risk metrics, as even conservative commentators argue repeatedly. This is especially driven by the mounting evidence for the negative financial impact of 'banning ESG' in the US.[1]

[1] A first study of the financial implications of 'banning ESG' by Wharton Business School academics showed financial losses (because of increased borrowing costs,) of ~300-500m in the first eighth months after the ban of the Texas pension fund (see SSRN working paper or Wharton summary).

The slower rise of ESG for VC

When it comes to private markets and especially early-stage startup investing, i.e. venture capital, adoption of ESG principles started much later. Even two and a half years ago, most VC funds in the US and Europe were oblivious of both process-focussed ESG and outcome-focussed 'impact'.[2] ESG was seen as irrelevant for early-stage companies and their investors and dismissed as either a blatant distraction or an onerous additional reporting burden.

Over the last two years, as investors, and particularly those in Europe,[3] have been preparing for the launch of the EU-wide Sustainable Finance Disclosure Regulation in 2023, ESG has started to become part of VCs' (and LPs') vocabulary too.

- **Public markets pushing down:** As ESG has become a 'license to operate' in public markets and public market companies are rated on their ESG performance automatically (influencing public market investors' decision making), going public (with an IPO) comes with 'going ESG'. In some cases where ESG was not adequately integrated into this process, public market investors refused to buy into the offering (e.g. Deliveroo) with serious consequences for VC financial returns. In sum, as startups grow and mature, later stage and eventually public market investors have increasingly been scrutinizing ESG credentials creating a trickle-down effect.
- **Learning from tech's mistakes:** The techlash has been going on for several years and tech scandals, from Theranos and Zenefits to WeWork and FTX, can be traced to ESG shortcomings. A lack of governance structures or missing awareness for the importance of DEI principles in building a viable company have become apparent in several instances. While we are seeing increasing regulatory and judicial clampdowns, (e.g. Theranos and FTX), shutdowns, bankruptcies or enormous devaluations (e.g. Zenefits, Gorillas) of tech companies in this vein, VC investors are starting to rethink their processes along ESG lines (e.g. on due diligence activities).
- **In line with societal shifts:** The learnings from recent tech scandals are also in line with a heightened societal awareness for topics ranging from social justice (#MeToo, Black Lives Matter) to climate change and economic (and worker) inequality (see also the #DeleteUber movement). This has a particular influence on the next generation of founders, employees, consumers, and VCs and the way they want to run companies and funds. ESG as one widely accepted 'toolkit' has become useful to integrate these

[2] For a simple differentiation consult our VentureESG White Paper #1; in short, while ESG concerns (internal) practices and processes, impact is about (external) outcomes.

[3] SFDR (and most other EU-level regulation) are relevant for investors and companies domiciled in Europe *or* soliciting money from and marketing to Europe, e.g. European LPs.

learnings and considerations into everyday VC and tech practices.

- **In line with the second wave of climate-focused VCs:** After the meteoric rise-and-burn of the first wave of (mostly Silicon Valley based) climate-focused VCs in the 2000s, the last three years saw the founding of many new green- and clean-tech focused funds and subsequently the funding of many climate startups. New communities of climate VCs have sprung up too, from Climate50 to the Net-Zero committed Venture Climate Alliance. While climate VCs are impact focused, their awareness for more general ESG (and sustainability)[4] principles is often heightened and the integration of ESG and impact will lead to better impact outcomes.

The rise of ESG for VC can also be tracked through the rise of new VC-specific organizations and service providers. Not only did VentureESG and ESG_VC[5] launch about two years ago, the PRI also started to focus more directly on VC in 2020. In parallel, a plethora of ESG reporting startups have arisen: from Atlas Metrics and ESGGen to Impact Nexus and specific carbon accounting platforms, these new service providers are focused on helping VCs and their portfolio companies collect and report on data, including to LPs. While the service provision market will consolidate over the coming years, their current rise is another indication of the growing importance of ESG for venture capital.

II.

Who are the LPs in VC

Since at least 2014, an increasing amount of money has flowed from limited partners into venture capital, with certain LPs not only increasing their allocation in VC funds but also engaging in direct investing in startups themselves. A decade of low interest rates across asset classes has contributed to this inflow of capital in private markets and led to LPs contributing well over $200 billion in 2021 to just shy of 1,400 funds worldwide. This 'dry powder' has been fueling record valuations and investment rates in the early 2020s.

[4] As described in the VentureESG White Paper #1, we take sustainability to go beyond climate concerns (green, E) to include the general

[5] ESG_VC is a reporting-focused organization working in partnership with BVCA to standardize startup (and VC) ESG reporting, with a focus on the UK.

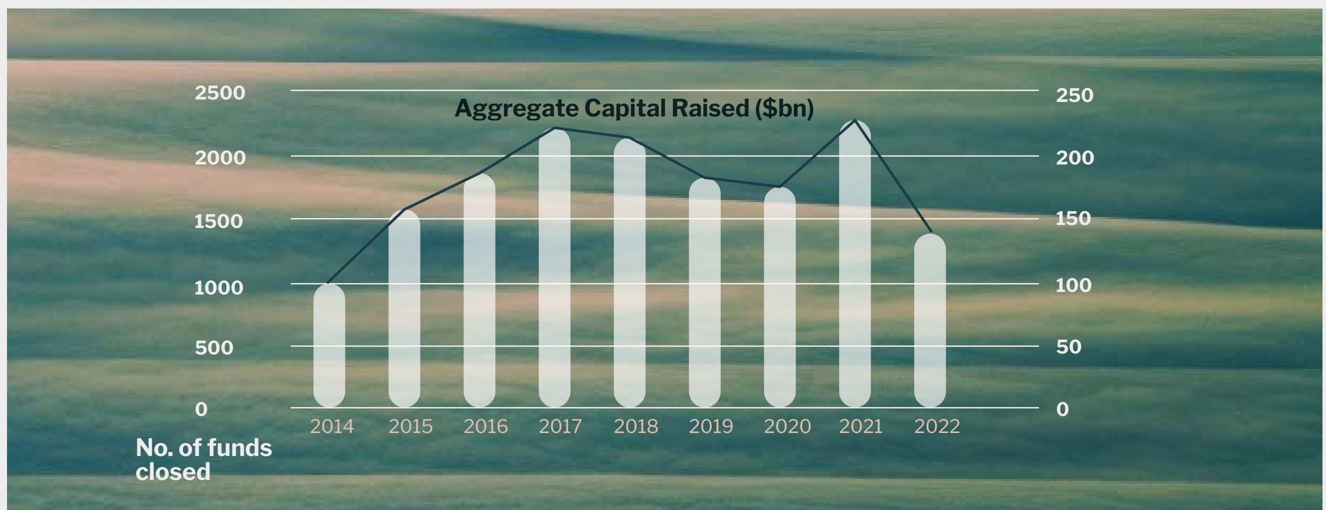


Figure 1. Global Venture Capital Fundraising, 2014-2022. Preqin Data.[6] PREQIN

Between 2017 and 2021, the number of institutional investors who allocated money to VC increased by over 60%, from 3,878 to 6,365. The largest LPs investing in VC (by number of fund commitments) are pension funds, with the US being home to the majority of the top 100 VC LPs, followed by Europe. Overall, the composition of the VC LP base differs distinctively geographically: in the US, the majority of the LPs are foundations, endowments and (private) pension funds compared to in Europe where state-owned money (both from government agencies and pensions) plays a more dominant role. Many European states have VC-focused vehicles[7] or act as anchor investors for their respective ecosystems. Within the US, of Preqin's top 100 VC investors, 49 are either pension funds (like the California Public Employees Retirement Systems (CalPERS) with 75 fund commitments) or endowments (such as the University of Michigan Endowment with 78 investments). The investor that tops this global list with 134 fund commitments is the European Investment Fund (EIF) highlighting again the dominant role of state-owned funds in Europe's VC LP base. Of the 11 European funds that are part of the the top 100 list, 8 are state owned and include the likes of the European Regional Development Fund, Tesi, and the British Business Bank.

[6] It is important to note that many foundations and endowments do not share information with Preqin; this data gap makes the numbers imprecise overall, but they remain indicative.

[7] For example: KfW Capital in DE, AP6 in SWE, British Business Bank / British Patient Capital in UK, BPI in FR, Tesi in Finland, Vaeksfonden in DK.

	US	EU
Endowments	21.2	2.6
Foundations	29.8	8.8
Government Agency	0.7	3.9
Private Pensions	24.3	20.3
Public Pensions	13.7	21.2
Family Offices	2.4	8.3
Insurances	2.3	7.7
Other	5.8	27.2

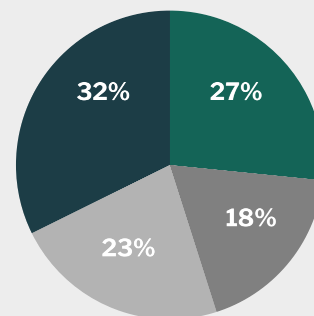
Long term financial investors

Government agencies

Other

Family offices & private individuals

LP base composition in Europe 2012-2016 ($bn)



LP base composition in the U.S 2012-2016 ($bn)

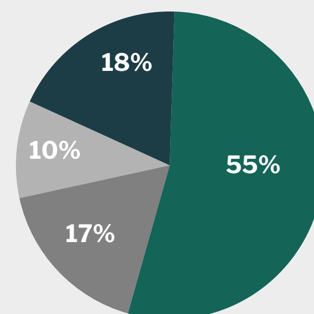


Figure 2. A breakdown of the contribution of different investor types to the total fundraising in the US (left) and Europe (right). These figures represent the allocation to the entire asset class of private equity, not specifically venture capital since filtering for those figures would be limited and inaccurate. Preqin Data. PREQIN

III.

How do LPs approach ESG for venture capital?

Within our sample of LPs, views on what ESG (environment, social, governance) means and how it was integrated into their processes varied significantly by LP type and geographical focus. Differences between Europe and the US are discernible and so are broad trends of which subfactors of E, S, and G are scrutinized. To provide a broad context for our empirical findings, we share three observations on general LP approaches to venture capital ESG.

1. Europe is committed to comprehensive ESG, US is slowly moving beyond DEI

The European state-owned and US-based pension funds we interviewed tend to have more comprehensive understandings of and approaches towards ESG. Not only do they try to capture a large variety of ESG KPIs in reporting, they also apply an ESG lens more strictly both in investment decision making and VC fund support. In contrast, many other LPs were single-issue focused and concentrated mostly on diversity, equity, and inclusion (DEI). This expressed focus on DEI (and at times climate) in the US rather than an integration of ESG comprehensively was also directly related by some interviewees with the American 'ESG backlash' over the last year. For European LPs, DEI issues are a subset of ESG and as such part of their broader ESG framework.

2. Among those LPs who consider ESG more broadly, certain themes stand out

We asked LPs which ESG factors they consider in early-stage VC investing. While the responses were wide-ranging and largely influenced by the firm's level of ESG sophistication generally, common themes across the three ESG dimensions emerged.

Environmental factors: Climate change-related factors such as CO_2 emissions are increasingly on top of the agenda for LPs as even traditional “tech” generalist managers investing mostly in software and internet start-ups can have a significant carbon footprint when scaling up and their energy and thus carbon intensity grows over time. Few other environmental factors (e.g. biodiversity) were explicitly mentioned as material[8] by VC LPs.

Social factors: Social or societal factors were the least pronounced when we asked LPs about their general understanding of and focus in ESG. The ‘social’ is not only seen by most as the least material (for VCs), but also the hardest to measure. This is with the exception of DEI which LPs position between S and G. Some expect the eventual influence of the European Social Taxonomy to change this over the coming years.

Governance factors: All of our interviewees agreed that governance-related issues in general were important for early-stage start-up investing. LPs particularly stressed the link between “good governance” as a common practice in reference to investor expectations about governance standards in public markets. Some LPs underlined the importance of governance factors — and the financially negative effect — for VC managers by highlighting negative examples such as WeWork or FTX.

3. Investors are referring to and using a number of ESG frameworks

LPs, and especially those in Europe, have for the last two years mostly referred to a number of different ESG tools and frameworks as ‘quick fixes’ which were not conceptualized with the VC asset class in mind. Many LPs (and some of their underlying VC funds) are members of the PRI (more on that below) and usage of the ILPA and IFC frameworks (developed for buyout investors and emerging markets respectively) and the SASB materiality framework (a very late stage and public market tool) was also common.

[8] ESG materiality is a key lens to define which ESG factors are relevant (for which industry, for which company); materiality provides an additional filter to enable a stronger focus. Our recent VentureESG White Paper #2 makes a first step in the direction of defining materiality for the VC ecosystem, jumping off from the SASB (now ISSB) methodology.

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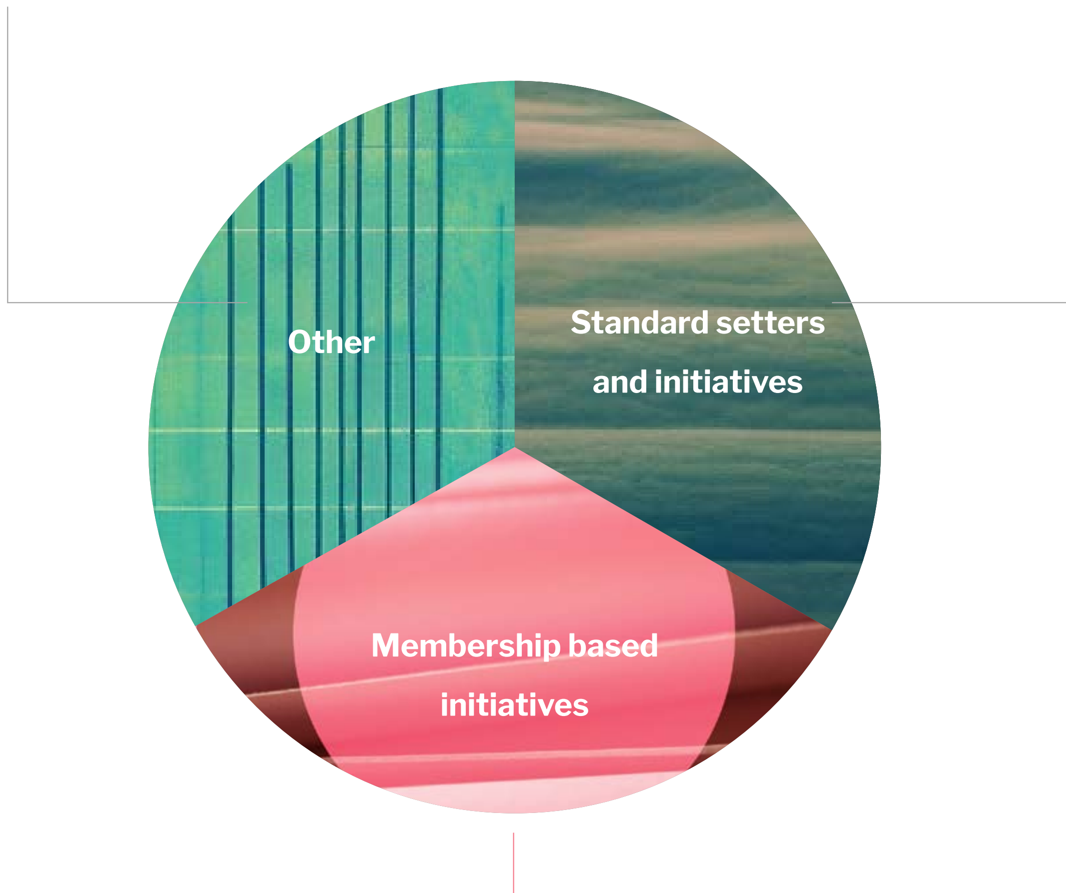

Figure 3.

IV.

Nine observations on LP ESG behavior

1. Existing ESG frameworks and reporting are not tailored to the VC asset class

Over the last decade, the number of ESG membership organizations and standard providers that offer a variety of frameworks to help investors to measure (and ultimately manage) sustainability-related issues in investment decision-making has grown substantially, as Figure 3 (previous page) suggests. And yet, most of the household names such as the Principles of Responsible Investment (PRI, founded in 2006) or the SASB materiality map are mostly focused on providing guidance to public and late-stage private market investors, while venture capital only recently started to enter the limelight.[9] This mismatch between existing frameworks and the specificity of the VC asset class was largely reflected in our interviews in which LPs highlighted that, although they utilize a variety of ESG initiatives and frameworks, none of them provides the fit-for-purpose solution for VC which LPs desire.

By far the most mentioned membership organization LPs rely on or refer to for their ESG practices and reporting was the PRI (Principles for Responsible Investment). About half of our respondents were either signatories or made use of some of the (free) tools the PRI provided. A number of the respondents were indeed content with these tools (e.g. the recent VC-specific PRI DDQ) and also with the PRI's agenda-setting function (e.g. bringing climate and science-based targets to the discussion table by including it in the reporting framework). However, interviewees also pointed towards problems with existing ESG frameworks, including the PRI's. The level of complexity of the reporting frameworks and non-specificity for the VC asset class were seen as major barriers for wide adoption. With a lack of accepted standards and best practices, LPs also pointed towards issues with judging the outcomes of any reporting exercise. Overall, ESG frameworks that are tailored to the needs of LPs and their venture

[9] See for instance the recent PRI report from 2022 on responsible investment in venture capital.

capital managers, including for reporting on the portfolio companies level and meaningful assessments specific for VC, are seen as much-needed.

2. 'ESG Confusion' is a possible but preventable threat

'Aggregate confusion', mostly produced by diverging ESG rating agencies, has been a persistent condition of ESG in the public markets. While ESG ratings are being scrutinized — by critics and also to prevent ESG-washing — a different kind of confusion is happening in private markets, including in venture capital, based on the lack of reporting and assessment standards.

Some of our LP interviewees observed how they themselves have been creating confusion. LPs, especially in Europe, which use a comprehensive approach to ESG, often require compliance to their 'proprietary reporting framework' (this is linked to the lack of available standardized frameworks, described in (1)). Not only has coordination between LPs been lacking so far[10], LP reporting (again only in Europe) will be further complicated by the Sustainable Finance Disclosure Regulation (in effect since April 2023).

A major factor in this confusion is LPs' exposure to a large variety of different companies, in terms of size, stage, and maturity. As one European LP described, it is unclear which type of reporting is not only mandated by regulation but also adequate and valuable for which type of company:

> *"But one of the biggest [...] things is we don't know how to report on this. So we're trying to build it from the UNPRI information. But what we've got is a million companies. Some of them are individuals, sole traders. Some of them are massive; [...] we've got all these different people who can all report at different levels. So we're trying to understand what we can require of our investing companies at each level going forward." (P 1)*

As European (and American) regulation is becoming established and an accepted VC-specific standard is missing, VCs currently often face competing requirements (reporting and otherwise). Going one level deeper, another LP explained how certain kinds of ESG factors are much harder to establish in a venture capital context than in later-stage buyouts. They explain with regards to carbon footprint reporting and the impossibility of comparing numbers across their portfolio:

> *"We are asking people to report their carbon footprint [across asset classes]. But in VC, we acknowledge that it is really difficult, but also really*

[10] Invest Europe has released a first ESG reporting template recently which might help coordinate LP action going forward (they are officially recommending LPs to use this from 1/1/2023 onwards). Similarly, the PRI VC DDQ which was released in November 2022 might have a similarly uniting effect on the investment decision making of LPs.

difficult for us, because we want to then have some relative intensity number [across the asset classes]; how do we do that for VC? For the rest of the established companies in the portfolio, revenue makes sense. But does it make sense in VC? [...] So we really are finding that a challenge." (P 2)

A final factor we observed[11] contributes to confusion on the level of 'why ESG matters' and the actors' motivations, as one interviewee explains:

> *"There is still a lot of ambiguity, where folks are taking action; some [...] are taking action because of a genuine belief that this helps them sell to founders better, exit companies better, and have a better process. And then some are doing it because they think that it is an opportunity for product proliferation or appeasing LP interest." (P7)*

A lack of unified understanding and education in the ecosystem overall precedes this confusion which can in turn facilitate ESG-washing.[12] ESG can become part of a narrative, e.g. vis-a-vis LPs, rather than being integrated into processes based on an understanding of ESG as a value-driver. Confused motivations can also lead to ESG's treatment as a tick-box exercise, preventing real integration and the realization of ESG's benefits.

Overall, coordination between LPs — and potentially also the leadership of a standard setter in parallel to the ESG Data Convergence Initiative — is missing from VC so far. This is a key factor that warrants attention and can help to prevent further confusion from spreading.

3. Top-tier exceptionalism in the US persists

Top-performing VC funds in the US tend to achieve significantly higher returns than the top performing European VCs (British Business Bank 2020). This puts them in an exceptional position of power and leverage, including when it comes to LPs' scrutiny of their ESG practices. Our interviewees described how this is limiting their approaches towards top-performing managers in the US, some of which are able to forego ESG reporting and disclosure requirements. This is true even for some European LPs with allocations in these top-tier US funds who otherwise care about good ESG integration (e.g. P17). One LP described the rationale for this exceptionalism:

[11] VentureESG strongly discourages understanding ESG as a competitive factor for VC funds (or a way for LPs to differentiate VCs); our mission is to enable the ecosystem as a whole to integrate ESG as standard practice and make it part of VCs' 'license to operate'.

[12] ESG washing can describe a practice where (public) narratives about ESG (integration) are not matched by action. Depending on the specific context, some talk about 'green washing' (when concerning the environment) or 'pink washing' (when concerning DEI) with equivalent meanings in mind.

“We don’t hold the balance of power. [...] I think it’s going to be a collective effort in the US and we need to form a united front to influence these access-constrained funds.” (P11)

While there is evidence that the long-term persistence of returns of historically top-performing funds is becoming less pronounced post-2010 (Cambridge Associates 2015, 2020)[13] and hence the LP persistence to invest in these funds is less rational, we heard many times that VC (and private equity more generally) is a ‘relationship business’. What this means for ESG (and DEI, as we will lay out below) is that LPs engage with their fund managers over time with the goal of using the influence and trust of their long-standing relationships to influence behavioral change. The danger of this approach is that the ESG agenda will remain marginalized longer, driven also by the tendency of younger and less established funds to copy what are perceived to be the top firms. In other words, where LPs feel they have limited influence over top-performing funds and where these funds are copied widely, we are likely to be dependent on the intrinsic motivations of some of the funds to embrace ESG for a longer time.

“Somewhat famously, [two big name VC funds] until very recently, were quite dismissive of ESG. And they would tell people who asked them that if they wanted to engage in charity, they’re welcome to take their profits and do that, but that they weren’t in the impact business [...] they may have changed their tune a little bit in recent years.” (P6)

The quote above by another LP underlines the exceptional position in which the most renowned managers find themselves in, and the influence they have over LPs. From the LPs’ perspectives, the trade-off has so far been perceived to be one between pushing for more ESG reporting (and integration) and having access to (historical) top-performing managers.[14] We have not observed a similar exceptionalism in Europe where especially state LPs, along with the impactful regulation, tend to have more market-making influence which almost no European fund is able to circumvent. European VCs are leading the way by showing it is possible to successfully integrate ESG factors and metrics across the VC value chains. By being co-invested in European funds, American LPs are seeing the evidence of what is possible, even at the early-stage, and hope to use this information to advocate for American GPs, including the top-tier ones, to make meaningful progress.

[13] A 2020 NBER working paper disputes this Cambridge Associates data with a large US dataset arguing that the VC ecosystem specifically continues to be characterized by persisting returns of top tier funds.

[14] PRI (2022) also highlighted that LPs tend to have little influence over top-tier (especially US) VC managers as asset owners that seek to conduct ESG-specific due diligence are sometimes “considered difficult”.

4. ESG factors influence investment decision making

For many LPs, ESG is not yet a hard criteria for their manager selection and investment decision making. ESG has become part of the due diligence conversation, relevant to many questions LPs have asked for a long time, e.g. on fund governance and diversity, as well as introducing new topics of scrutiny and conversations, e.g. on environmental footprint. Some LPs are planning on slowly raising the bar of ESG in the future, as one European LP proposed:

> *"[At the moment], we don't have a hard bar like 'we won't invest unless you have an ESG strategy'. But in the future, we will be asking all of our managers to be on that page – that reflects the broader market approach we take." (P15)*

Other interviewees have integrated ESG into their general diligence already, but without demanding specific predefined requirements or as part of a tick-box checklist exercise. One LP with a very critical and long-standing ESG approach to VC explained:

> *"[We have] no hard requirements anywhere in our process, so not for venture or not for ESG. So yeah, there's certain things that we like to see, but we have no hard requirements." (P6)*

The approach of engagement and working with GPs to drive progress over time was mirrored by many of our LP interviewees. There were only a few exceptions to this rule; one of the only categorical criteria LPs used were related to governance factors, as the following quote illustrates:

> *"We require Big Four auditing firms in the US. One big fund we invested in agreed to change auditors (from a locally well known firm to a Big Four firm) after one year already, but that's more on the governance side."*
> *(LP Participant in SuperVenture Roundtable discussion, June 2022)*

About half of the LPs we interviewed also used (and required their VC funds to use) specific exclusion lists. While the lists were at times modeled on the IFC exclusion list, many LPs had asset-class specific exclusions for VC. Some of these restrictions included investments in new and unproven industries like crypto/ web3; most, however, were focused on expectable issues in parallel to public markets exclusions, such as gambling, porn, fossil fuels, or tobacco.

Across our interviews, a minority of LPs considered a lack of ESG integration at the moment of fundraising a 'deal breaker' and some would impose post-closing ESG

conditions (e.g. writing and publishing an ESG policy, engaging in ESG training) onto the funds, including in side letters. Some also considered a lack of progress when it comes to ESG integration a reason not to continue to commit capital. Similarly, bad handling of ESG-related incidents could lead to such a decision for some LPs. Overall, an even bigger group of LPs we interviewed believed that ESG could influence their decisions going forward and the early conversations in the US (e.g. around encouraging VCs to adopt ESG policies) are powerful starting points. Where regulation is not a strong driving force, collaboration and pointing towards the value of ESG integration and providing meaningful resources are promising ways forward.

Deep-dive: Diversity, equity and inclusion

The lack of diversity across the asset class — from senior VC investors to the founders they invest in — has been well-documented. Given that the diversity of VC decision makers (GPs) and founders who receive VC funding has changed very little over recent years[15], what role can LPs play to finally push for change? We understand DEI as a part of ESG and spent a significant portion of our interviews covering DEI practices among LPs. In essence, while many are collecting data, at the moment few are treating DEI in its full complexity and making decisions based on available data, given its proven direct bottom-line implications.

DEI

5. Limited view on what DEI incorporates needs to be expanded

When asked how they understand DEI and how they implement it within their investment framework, most LPs we interviewed focussed on gender. Many dimensions of diversity which can include factors from gender and ethnicity to socio-economic status (or class), ability, age, and sexual orientation among others, are rarely conceptualized or metricised by LPs or VCs. Many LPs quoted a lack of experience and available data as reasons for their approach to DEI. Several LPs confirmed their struggle with the limited focus:

> *“We only look at gender and ethnicity [...] but primarily, we’re trying to measure the percentage of women ownership” (P6)*

> *“There has been a general push to promote diversity [...] but I will say it has been tricky in a way that it is mainly [focussed] on a male/female aspect” (P3)*

> *“It is predominantly gender [...] we’ve got a number of LPs [as investors in their fund of fund] that actually specifically look at diversity and inclusion,*

[15] See Techcrunch 2022, State of European Tech 2022 and ‘European Women in VC’ report for the latest numbers.

and in those strategies it is a bit different [...] but I think [gender] is the theme where we have some depth in terms of portfolio experiences" (P15)

Critics from the right — epitomized by Woke, Inc author Vivek Ramaswamy — doubt the effect 'skin-deep diversity' initiatives have overall, which at least in the US has a certain pull on the DEI movement. But among our interviewees, many are reflective on the shortcomings of only focusing on the lower-hanging fruits of gender and ethnicity. Reasons for the widening of the DEI scope LPs mentioned ranged from regulatory pressure to genuine understanding of the importance of true representation of underrepresented groups.

> *"[we are interested in what] general partners are doing in the broader ecosystem to support diversity, and then specifically with their team members to support women or people from underrepresented minority backgrounds [...] but diversity is a lot more than that" (P8)*

> *"[in Germany some are focusing on] including disabled people into the startup area, because you have to pay a decent amount of money in Germany, if you do not have at least 5% of people in your company with a disability [...] you can save money by building a more inclusive ecosystem" (P4)*

> *"there is one that I've been paying more and more attention to recently, I think it's a really important one [for VC], it is also a bit of a delicate one: socio-economic background." (P17)*

Especially the inclusion of consideration of socio-economic status -—standard practice in e.g. university admission[16] — seems crucial given the estimate that 40% of US VCs went to Harvard or Stanford. Across geographies, questions remain around what DEI statistics should be the focus and what metrics are even legal to ask about.[17]

Several initiatives, most importantly Diversity VC's Standard, are tackling the confusion in this space. On the LP level, the Institutional Limited Partners Association (ILPA) have published standardized metrics, further adjusted for the VC ecosystem by Canadian Crown Corporation, BDC Capital. BDC Capital has furthermore driven a Canada-wide LP coalition around reporting a standard set of DEI metrics in VC pointing towards a standardized, but multidimensional future of DEI for the asset class.

[16] See these diversity and inclusion statistics which Oxford publishes openly every year after their admissions cycle; the argument for their publication is that transparency can create accountability which in turn can foster change over time.

[17] Several countries, such as France and Germany have legal barriers to e.g. collect ethnicity data (Guardian 2020). Several of our interviewees pointed towards this regulatory challenge.

DEI

6. LPs are increasingly 'asking the questions' to overcome lack of data, but so far only limited progress has been made

Partly connected to the lack of standardized definitions of ESG and DEI across geographies, the availability of consistent DEI data has been flagged repeatedly as a hindrance by our interviewees. In order to overcome this 'missing data problem', VC LPs across the board have become more committed to 'asking the question':

> *"every DD process [...] there is a diversity and ESG lens [...] do they have a team that's just old white men? From an opportunity perspective, there are things that we think are quite conducive to positive outcomes" (P17)*

> *"we require gender breakdowns. [If they are] 2x qualified, then they have a lot of gender focus reporting, in terms of how the fund and or portfolio is qualifying for 2x. So they would need to break this down based on all those different things" (P14)*

> *"[We ask GPs questions like], what approach have they pursued themselves for creating at the management level gender diversity and what is their ambition in the portfolio companies?" (P15)*

> *"there is an element of our strategy, which is to look at diversity managers [...] that is something that we are looking to expand and invest in as part of the broader approach to inclusive capitalism [...] also looking at diversity metrics, how many of the partners are non male? What's the approach that they're taking going forward with, with regards to recruitment, etc? These are all important questions that we asked at the time of our investment, but also going forward" (P18)*

However, the scope of data collection often remains limited. The sensitivity of DEI data (e.g. around ability or ethnicity) and the inability to track this data was mentioned repeatedly as a major barrier:

> *"I think class is very important. I think it would inevitably be much harder to track that, how would you define it? I think that's always the challenge that you have, particularly in the UK, where it's not necessarily just purely around wealth." (P14)*

As a result of the inability to benchmark and to fully understand best practices and even best practice definitions and metrics, very few LPs make DEI progress conditional for investment or re-upping.

“we haven’t gotten to a point yet where we’ve said like, we’re not going to invest with this firm anymore because they’re not making enough progress on diversity because I think the tricky part there is if you stop investing on that basis, then you give up your seat at the table, and then you don’t have the opportunity to have those conversations anymore” (P8)

“we don’t have any genuine penalties [...] we don’t have a quota [...] we basically ask from the perspective of [...] being a plus, because we believe that having this type of gender diversity is a contributor to the outlook on the financial performance of the fund and from that perspective, we take it into our assessment as being an upside rather than being something where we would eliminate a deal because it has not met the eligibility criteria” (P15)

However, we heard from a small number of LPs that, for instance, completely new commitments to managers they hadn’t backed before would only be made to diverse teams. This approach, if followed widely, would slowly diversify the VC ecosystem from the top down.

DEI 7. DEI as a first step on the ESG journey — an American approach

As discussed above (Observation 2), approaches to ESG and what is included in its definition vary across geographies. Overall, many critics have focused on the complexity of ESG and called for a de-escalation of the ever-growing non-financial factors included in reporting requirements.[18] One method of (initially) reducing this complexity we observed as especially popular among US LPs is to focus on one or two aspects of ESG in their engagements with VCs. Often, one of these focus points tends to be diversity (or increasingly carbon accounting), as several LPs described:

“[we do not ask about] ESG, broadly, but diversity, absolutely, [...] we continue to talk about [...] what factors they will consider when trying to hire someone new, what kind of culture is established at the firm, [...] how different voices get included, so yeah, we definitely talk about diversity, equity and inclusion on a very regular basis and on a qualitative basis with our managers [...] the effort I know, in the US, is to back more diverse firms, [...] what we think about the most is the composition of the team, both how it stands today, as well as what firms are doing to change the

[18] One intervention in 2022 came from the Economist calling to radically reduce ESG complexity to focus solely on emissions; many defended the necessity to hold up the complexity but focus on radical materiality filtering (e.g. Responsible Investor’s direct reply to the Economist article). A critique very common among VC investors is the focus on reporting (which usually stems from misunderstanding about what ESG is overall, see Observation 2).

composition of the team or evolve the composition of the team over time" (P8)

"[what we have seen is that] in the US, diversity has stuck [and received] a lot more momentum within the private equity industry [...] whereas in Europe, it has been more focused on climate, [...] one of the early factors was in 2017, with the "whole MeToo" movement [...] I think that for a lot of folks this opened their eyes [...] and has led to some kind of early steps towards improving practices around DEI, [...] it even intensified further following the George Floyd murder and the unrest in summer of 2020" (P6)

The geographically-specific cultural developments connected to both MeToo — epitomized among others by the Ellen Pao lawsuit from 2015[19] — and the Black Lives Matter movement following George Floyd's murder, were cited as major factors in this focus of DEI (as a first step on a longer ESG journey). Many US VC investors pledged to change their hiring and investing behavior in 2020 — unfortunately so far with limited impact.

Unfortunately, some interviewees were not convinced that the DEI focus will remain in place going forward or create the long-awaited impact on money being distributed differently:

"There was a lot of capital to back new managers over the last two years [...] since George Floyd's murder, but are people going to just regroup and say, look, the market's hard, we're just not going to take much risk right now and we gave it a shot, [...] so will people stop adding more diverse firms or care less about that because they just have to focus on maintaining the corpus of what they have?" (P8)

[19] Ellen Pao lost a lawsuit against Kleiner Perkins in 2015 in which she claimed KP had discriminated against her based on her sex (and not promoted her). Pao subsequently published a book (Reset) and has become an activist in the space.

Positive view towards the future

Despite a slower start across the ecosystem and despite doubts about the possibility of integrating ESG comprehensively especially across the American, more fragmented LP landscape, our interviews showed that ESG has very strongly arrived on VC LPs' agenda. As we have argued in ImpactAlpha, including quotes from some influential European LPs on the record, the ESG for VC push is only just getting started.

8. ESG is here to stay across geographies, but sub-issues require specific attention

Across our interviews, the outlook on the future of ESG was positive if somewhat more so in Europe than in the US. Most importantly, ESG is generally seen to be on an 'upward trajectory' from a reasonably low starting point right now. We are quickly moving up the 'learning curve', as one LP explained in our conversation:

> *"I think it's becoming harder and harder to ignore. I do see even though we're starting at a low baseline of understanding [...] the conversations that I've been having [...] it's definitely on an upward trajectory. But we're [where] buyout was in 2015. [It will] take some time for things to ramp up." (P11)*

In the future, ESG will become a standard 'license to operate' rather than any kind of competitive criteria. As one LP explained:

> *"my view is that ESG and sustainability issues are here to stay [...] I really want to think that in 10 years from now, when we will look at the past, we will think how come we didn't look at all these things before investing and I cannot see [us going] backwards, that would be a disaster for the whole planet, we are investing in the future champions [...] that have the power to change paradigms, so [...] ESG [has] to be here, and it's something that has just begun" (P19)*

When it comes to ESG sub-areas, one was especially emphasized. The nascent focus on climate — both as an ESG consideration but also as a sector for skyrocketing VC investment — was mentioned across interviews and is mostly welcomed. This has been strengthened by the political backing across

geographies (with the US' recent changes in its climate regulation as well as the new EU taxonomy). One US-based LP made this argument very strongly[20]:

> *"from [our] perspective yes, [we believe ESG and sustainability will be a strategic concern for managers in venture], [...] it is a long term secular trend as the world continues to recognise environmental risk and opportunity, predominantly due to climate change, but also as a variety of other sustainability considerations are reshaping the world [...] if you're not being thoughtful about it, it will affect your sector at some point [...] it is a pervasive theme" (P7)*

One of the core requirements which LPs pointed towards to create real change is the necessity of senior leadership buy-in. LPs and GPs need to put ESG (and sub-issues such as DEI) on the agenda regularly (including in portfolio company board meetings) and allocate resources to fulfill the additional work required.

> *"it was not until our current CEO that there was [...] senior level support, and now this is an area we will start investing in, [we will do this] across the organisation (P3)*

9. Regulatory requirements and lack of standardization might temporarily slow down the show

The first ESG disclosures[21] from European funds (and their portfolio companies) will be required this year under SFDR regulation. While the overall positive impact of SFDR to 'get the industry moving' is clear especially for European LPs, many LPs (as well as our GP community) are concerned about the near-term impact of regulatory requirements which are (again) not VC-specific. We are expecting 2023 to be a year of ESG-moaning, both from GPs (about their own requirements to regulators and LPs) and portfolio companies. The chances of quick adaptation of the EU regulation to adopt to the VC asset class specifically are small; however, our interviewees were more hopeful about market participants changing:

> *"This [ESG KPI standardisation] is not going to come anywhere soon. But I think it will be preceded [...] by market developments that are driven by stakeholder behavior." (P15)*

Several LPs also observed that more nuanced approaches to both ESG and

[20] One interviewee pointed out a further tension with this focus on the E for VCs and startups in particular is that many are in low emitting industries where standard GHG/climate focused ESG analysis shows little impact. This insight could lead to the conclusion that ESG overall is not as important in the ecosystem and hence a lack of focus on ESG integration overall.

[21] We often talk about SFDR equivalent of ESG; in fact SFDR stands for 'sustainable finance disclosure regulation' and hence points towards a different vocabulary ('sustainable finance'). As we laid out in our White Paper #1, we prefer to stick with the term ESG (for its higher specificity); SFDR disclosures are very similar to our ESG 'universe of issues'.

impact are already in the making. While several GPs and LPs struggle with definitions (see Observation 2), others are pushing ahead with very clear requirements and demands (including VC-specific LP reporting). Impact in particular is quickly becoming the next nuance VCs are focusing on as one interviewee described:

> *"I've seen folks start to try to draw these boundaries between what is ESG and what is impact, partly because the caliber of high performing ESG strategies is also going up, it's not just reactive and retrospective anymore. It's increasingly prospective, and proactive" (P10)*

With an increasing resurgence of especially climate-impact focused VC funds over the last three years, including the emergence of several specific climate-VC networks such as Climate50 or ImpactVC, a first step towards a VC impact-turn is well underway. However,what we need to be careful with, and even more so with impact entering the game more strongly, is the analytical differentiation between ESG and impact which sophisticated LPs (and VCs) are very aware of.

V.

Conclusion and recommendations

The goal of this paper was to collect interview-based empirical evidence to add nuance to LPs' approaches to ESG in VC. Built on the strong belief that it is predominantly LPs (and regulators) who can and will shape what ESG in VC will look like, the observations we focused on above provide an overview of the current state of play. VCs have a very important role to play in shaping what ESG looks like 'on the ground', especially on the portfolio company level, but we want to end this paper focused on recommendations for LPs. To conclude, we present three ideas for LPs on how they can ensure the VC ecosystem will integrate ESG in a meaningful way going forward.

Recommendation 1:
Let's not treat disclosures, KPIs, and metrics as the end point and focusing on practice instead
While EU-regulation is so far focused very strongly on ESG metrics and disclosures, change in the ecosystem needs to go down to the level of practice. How do VCs integrate ESG criteria into their investment decision making (e.g. as explained in their ESG policies)? How does it influence their internal fund management and portfolio support practices? Quantitative metrics and disclosures will only be able to touch on some aspects of ESG integration; more importantly, measurement for VCs and their portfolio companies might not yield any significant results given the nascent stage of the company. Qualitative and conversation-based due diligence (and engagement around practices, see below) from LPs can be a strong mechanism that goes beyond transparency and accountability towards practical change. This could begin with a focus on issues of company culture and good governance. The PRI's VC-specific DDQ can be a conversation starter for this purpose.

Recommendation 2:
Standardization of LP reporting
In order to avoid the 'aggregate confusion' that defines ESG in the public markets at the moment, including among the institutionalized ESG rating agencies, LPs

need to work together to provide clear guidance. We believe that especially in Europe, LPs have a chance to unify their ESG requirements, given that many of the European LPs are state funds whose mandate goes beyond maximizing returns. Standardizing their approach, starting at the reporting level — similar to the ESG Data Convergence Initiative — presents itself as a good first step on pushing the industry forward from the top-down. Standardized reporting templates, such as that from Invest Europe, can serve as starting points for the conversation. This will also immediately relieve pressure (created by a multitude of different reporting templates) on the VC managers and their portfolio companies.

Recommendation 3:
Towards consequential engagement

If LPs engage with managers on ESG integration beyond reporting, we recommend that they should adopt a consequential approach to engagement that includes setting a clear timeline with specific requirements (which are to be met by VC managers), and deadlines, and (crucially) also includes a credible threat of divestment (or not 're-upping') if requirements are not met. Some LPs are already making investment conditional on post-investment ESG integration (e.g. write and publish an ESG policy within six months post-investment). Without integrating such requirements into legal documents, engagement with managers is more likely to remain ineffective. In the area of climate investing, this approach is currently in the test phase among several Colleges of the University at Oxford based on the Oxford Martin Principles for Climate Conscious Investment. They have adapted their investment policies to adopt a new engagement strategy with their asset managers and with companies in which they hold direct investments that could be characterized as 'consequential engagement'. This approach and the underpinning theory of change is overall based on a clear and transparent communication of expectations, time frame, deadlines, and consequences in advance.[22]

[22] There is also new research highlighting the co-benefits of combining engagement and divestment strategies in public markets.

VI.

Appendix. Method and sample

We interviewed a group of twenty-five individuals from twenty-two institutional limited partners, mostly focused on and investing in the US and Europe, but with some exposure to emerging economies. The limited partners which we refer to with P1 to P25 (for anonymity purposes), ranged from state funds (7 fell into this category) and pension funds (4) to endowments (4), specialized fund-of-funds (FoF)(5), and financial institutions (2). We conducted semi-structured interviews lasting between 30 and 90 minutes; all interviews followed the same informal interview outline. All interviews were conducted by mostly two and in rare cases only one of the three authors. Based on the consent of the participant, the interviews were recorded and transcribed with the help of Otter.AI. The interview transcripts served as the empirical data which we used to generate the insights and observations this paper is based on. All quotes used in this paper are verbatim and changes are made for clarity and indicated clearly with [...]. To protect the anonymity of all our research participants, we do not attach names or institutions to quotes throughout the paper.

After the data collection phase (June to November 2022), the data analysis phase (December 2022 to February 2023), and the write-up of the first draft paper, we consulted all interviewees and a wider group of LP stakeholders again in February and March 2023. We incorporated comments and additional feedback to produce the final version of the White Paper; all reviewers who provided comments are listed on the title page (either by name/institution or as ‘anonymous reviewer’). We also consulted the VentureESG academic advisory board for additional feedback; all members of our academic board who provided feedback are also listed as reviewers on the title page.

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