Pääomasijoittajat
Finnish Venture Capital Association

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Recommendation on sustainable investment in the venture capital and private equity sector

Assessing and managing the opportunities and risks associated with sustainable investment and corporate responsibility has become part of the daily business of venture capital and private equity funds and their investee companies. The regulation on the consideration of sustainability risks and factors was put in place in 2021, and is expected to become even more important in the coming years.

The Finnish Venture Capital Association (FVCA) considers sustainable investment and the promotion of diversity to be important concerns of the venture capital and private equity sector. For these reasons, FVCA has taken the following measures:

1. We have incorporated the regulations that apply to sustainable investment and diversity into our openness and transparency recommendation and Code of Conduct, which the association's full members have undertaken to follow in their business activities.
2. We have made a recommendation on how investee companies can put concerns related to sustainable investment and corporate responsibility into practice in their operations, taking into account the valuation, value creation and exit stages of the investment.
3. We provide our members with information and training on responsible investment and corporate responsibility, and conduct research on the development of sustainable investment and diversity in the sector.

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1. Principles of sustainable investment as part of the Finnish Venture Capital Association's Code of Conduct and openness and transparency recommendation

The association takes sustainable investment into account as part of the association's rules openness and transparency recommendations.

According to the Code of Conduct, full members of the association must uphold the principles of sustainable investment in their activities.

In addition, the recommendations on openness and transparency in the venture capital and private equity sector require general partners managing venture capital and private equity funds to maintain a website with up-to-date information on the sustainable investment principles that applies to the fund and related matters.

2. Regulatory obligations concerning sustainable finance

The Sustainable Finance Disclosure Regulation (SFDR), which came into force on 10 March 2021, requires alternative investment fund managers to disclose information on the integration of sustainability risks and adverse sustainability impacts in their own activities and in the funds they operate.

The SFDR harmonises terminology and reporting on sustainability risks and adverse impacts related to sustainability, and specifies what information must be disclosed about investments that are marketed as promoting environmental or social attributes (SFDR Article 8) and as sustainable investments (SFDR Article 9).

In addition, from 1 August 2022, under the Alternative Investment Fund Managers Directive (AIFMD; Directive 2011/61/EU), general partners managing funds are required to consider sustainability-related risks and other factors in organising their activities and in the management of risks and conflicts of interest.

The Finnish Venture Capital Association has drawn up a separate Sustainable Finance document containing detailed information on all the legislation related to sustainable finance and its application in the venture capital and private equity sector. The association recommends that its members familiarise themselves with this document.

The FVCA requires all its full members to comply with the new legislation and to provide the information required under it on their websites and in materials related to their products.

In addition, the FVCA recommends that in formulating their sustainability strategy all companies align their terminology with that of the SFDR and apply the indicators defined in the SFDR.

3. Recommendation of the Finnish Venture Capital Association (FVCA) for sustainable investment and corporate responsibility of portfolio companies

The FVCA recommends that its members take a structured approach to sustainable investment and corporate responsibility. Sustainable investment and corporate responsibility can be integrated into business operations in a variety of ways. The policies to be applied depend significantly on several factors, among them the company's investment focus, its investment strategy, the geographical area of operation, and the size and stage of development of the investee companies. It is therefore essential that each operator determines and specifies the sustainability factors and policies relevant to its own investment activities.

Assessing the opportunities and risks of sustainable investing and corporate responsibility enables the identification of new sustainability-based business opportunities and value creation for the investee companies. In addition, due diligence regarding sustainability helps companies to avoid significant business risks. Limited partners – that is, third-party investors in a venture capital or private equity fund – are committed to ensuring sustainability in their investment activities, and it is therefore important that general partners – venture capital and private equity firms that manage venture capital and private equity funds – also incorporate take sustainable investment principles and corporate responsibility criteria in their investment processes, and communicate this accordingly.

The sustainability recommendation of the Finnish Venture Capital Association is divided into the following themes:

3.1 Determining sustainable investment and corporate responsibility objectives

The purpose of incorporating sustainability considerations into an investment strategy is to ensure that investors are clear about how sustainability risks and opportunities are taken into account in investment activities and in the selection of portfolio companies. Underlying the sustainability strategy is an understanding of how the choices made improve the risk-reward ratio of investments.

The sustainable investment principles translate the objectives of the sustainability strategy into action.

3.1.1 Sustainable investment principles

The following should be included in a sustainable investment principles, taking into account the size and nature of the operator:

- Sustainable investment principles must define what sustainable investment means in the investment activities of the operator concerned, and how sustainability will be taken into account in the investment policy. A typical starting point for sustainable investment is to consider environmental, social and corporate governance (ESG) risks and opportunities in order to improve the risk-reward ratio. However, this should be done in concrete terms, and should be based on the specifics of each operator's investment activities.

- A key element of the policy must be the inclusion of information on how investee companies are chosen, and the sustainable investment approaches an investor uses to assess sustainability risks and opportunities. Typical approaches include exclusion, norm-based valuation, favouring ESG over non-ESG funds, ESG integration and active ownership.

  Sustainable investment approaches must also be made more concrete by explaining how the investor uses them and how they are designed to increase the value of the company.

- The internal chain of responsibility must also be specified: what party is responsible for assessing the sustainability of investments in practice and, among other considerations, how any sustainability-related shortcomings that are detected are communicated within the company and who is to be made accountable for them, whether the shortcoming is recorded in the log or discussed as part of e.g. risk management or by the board of directors of the company.

- The policy should describe how and at what stage of the investment and ownership process various sustainability approaches will be taken (the investment lifespan from project flow, due diligence, negotiation and ownership to exit). It is also useful to indicate whether the approaches extend to any subcontractors of the investee.

- A description of the reporting process for the investment that is to be provided to the investor may also be part of the sustainable investment policy, or it can be included in the sustainable investment action plan.

- The sustainable investment principles should be approved by the member company's board of directors.

3.1.2 Sustainability considerations and criteria

The sustainability considerations for investment activities are sector-specific and company-specific, and are based on the following areas:

- The environment
  - Among the environmental criteria that must be considered are management of harmful emissions and waste, energy efficiency, mitigation of biodiversity loss, ensuring the coverage of certificates and that environmental permits are up to date.

- Social considerations
  - Among the social criteria that must be considered are the standard of working conditions, minimising accidents at work, compliance with international human rights conventions, diversity and equal pay in the investee companies and their management.

- Good governance
  - Criteria for good governance include clear and documented remuneration systems, transparency in tax payments and fund structures, avoidance of corruption and otherwise unethical business practices, and clear decision-making procedures.

3.2 Accommodating sustainable investment and corporate responsibility during the investment phase

Broadly speaking, in the investment phase there are three ways in which a fund's sustainability strategy can be promoted: i) in management of the project flow; ii) in the appraisal phase; and iii) at the transaction phase, i.e. when the investment is being made.

(i) Project flow management means that the general partner (GP), through its own activities (e.g. communication and focusing of its internal resources), aims to ensure that as many targets as possible that are in line with the funds sustainability strategy are included in the fund's potential investees, i.e. in the project flow. Taking the sustainability strategy into account at this stage makes it easier to monitor the strategy at later stages.

(ii) When going through the project pipeline and evaluating a potential target as a new investment for the fund, the GP must ensure that the investment to be made is in line with the GP's sustainability strategy.

(iii) In addition, at the transaction stage of an investment, where possible the GP should ensure that the investment and the transaction meet the sustainability criteria set for them. This should be done with the assistance of their advisors. This procedure entails checks and assessments at the transaction stage, and requirements and guidelines that are determined on the basis of these for guiding the portfolio company's operations to ensure that they meet the GP's sustainable investment criteria.

3.3 Integrating sustainability and corporate responsibility into ownership practices and the exit phase

Active corporate governance and careful preparation of the exit phase can contribute to the implementation of the fund's sustainability strategy during the ownership period and upon exit:

(i) Active corporate governance means that the general partner (GP), as the owner, endeavours to increase and safeguard shareholder value by promoting sustainable business practices in the investee company and focusing on sustainability-related factors that are relevant to the portfolio company's operations. In the case of the key sustainability considerations, it is advisable to define clear objectives for the investee company and monitor their achievement over the course of the ownership period with the aid of clear, pre-defined indicators. Active corporate governance on sustainability issues requires that the board of the investee company be aware of the sustainability strategy of the general partner, and that the board of the investee company has sufficient expertise in the sustainability-related matters in the industry in question. It is essential that these matters are regularly on the agenda of the board and operations management of the investee company. We recommend that the investee company report regularly to the fund's investors on the implementation of the investee company's sustainability strategy as part of its other regular reporting.

(ii) In the exit phase, we recommend that the investee company highlight the standard of its management of sustainability-related matters and the current status of these matters in its operations. At the same time, the investee company should describe the future opportunities for value creation related to sustainability.

4. Sustainable investment and the limited partner's (LP) perspective

Investors in venture capital and private equity funds, and institutional investors in particular, generally take sustainability into account in their investment activities, and each has its own policies and guidelines related to these issues. In addition, the Sustainable Finance Disclosure Regulation (SFDR) and other sustainability-related reporting obligations require many institutional investors to consider and report in a specified form on sustainability risks and adverse sustainability impacts.

When looking into a general partner (GP) and conducting due diligence on it, investors are interested in the management company's principles and practices related to sustainable investment.

When deciding to invest, institutional investors require that the management company's commitment to sustainable investment is also expressed in the fund's partnership agreement or side letter agreements.

During the life of the fund, the investors will each require some level of reporting from the general partner on the corporate responsibility status of the portfolio companies and on the general partner's sustainable investment activities.

Investors' perspectives on sustainable investment and their expectations of general partners vary widely, depending on the size of the investor, their geographical location, their own interest and commitment, and their previous experience in this area. For these reasons, different institutional investors towards general partners may even be partly contradictory.

The Finnish Venture Capital Association recommends that the general partner take account of the requirements and indicators of the SFDR and the regulations pursuant to it, and create their own clear approach to these matters. This can be done in various ways, for example in terms of due diligence materials, the relevant content to be included in fund contracts and the level of reporting. This will provide them with a basis for approaching investors and developing a model that satisfies all investors.

The Finnish Venture Capital Association's recommendations for general partners in preparing for fundraising in relation to sustainable investment:

At the level of the general partner:

- the general partner company should define its approach to sustainable investment and how sustainability risks and adverse sustainability impacts are to be handled (confirmed operating principles);

- the general partner should determine and describe how sustainability risks are taken into account in its remuneration and publish this information on its website (excluding registered operators);

- the general partner should specify how matters related to sustainable investment are integrated into the management company's investment process (checklists, use of consultants, investment memoranda, etc.);

- the general partner should consider whether it wishes to engage with public bodies that uphold sustainable investment standards (e.g. the PRI, an investor initiative in partnership with the United Nations Environment Programme Finance Initiative (UNEP) and the UN Global Compact), whether as a member, signatory or otherwise, and whether it wishes to be part of bodies that promote sustainable investment (e.g. Finland's Sustainable Investment Forum (Finsif), Finnish Business & Society (Fibs));

- the general partner company should appoint a person, preferably at partner level, who is in charge of matters relating to sustainable investment.

Legal documentation of the fund:

- the general partner should include a section on sustainability risks and adverse sustainability impacts in a private placement memorandum (PPM), i.e. an investment memorandum that also includes a description of the expected impact of sustainability risks on returns;

- the agreement between the fund's shareholders or the fund's side letter agreements should include a reference to the general partner's sustainable investment principles;

- the general partner must be prepared to confirm in the shareholders' agreement or the side letter agreement of the fund that it is aware of the investor's commitment to sustainable investment principles;

- if the general partner offers investees in accordance with SFDR Article 8 and Article 9, the periodic reports must include reporting on the implementation of the sustainability features in the format required by the SFDR.

In relation to reporting, the general partner must explain how it will deal with the following matters:

- reporting on sustainable investment issues in the context of quarterly or other regular reporting (e.g. in the Investor Reporting Guidelines section of the Invest Europe Professional Standards Handbook);

- ad hoc reporting at the request of investors;

- preparation of the annual report on sustainable investment;

- any other public communication as required.

5. The Finnish Venture Capital Association's (FVCA) recommendation for diversity in the venture capital and private equity sector

The Finnish venture capital and private equity sector plays a key role in social development and in the growth and development of companies in Finland. Studies show that teams with a broad representation of people from different educational backgrounds, ages and genders perform better than homogeneous teams. Increasingly many limited partners are also paying attention to the diversity of investment teams and the diversity of investee companies owned by venture capital and private equity investors.

The FVCA considers broad-based representation of people from different backgrounds and genders to be essential in the sector. The FVCA recommends that its members ensure diversity in their own operations and management and in those of companies they invest in.

6. The Finnish Venture Capital Association (FVCA) provides information and training for members

Sustainable finance is one of the priorities of the FVCA's strategy for 2022 and 2023.

The association provides its members with information and training on how to ensure that their business investments are sustainable. The FVCA provides guidance for its members on sustainable finance legislation and its implications, and has also held webinars on the subject. In addition, the association maintains a dialogue with the European Securities and Markets Authority (ESMA) through the FIN-FSA Financial Supervisory Authority and Invest Europe to provide its members with up-to-date information on the rapidly changing regulatory environment and its effects.

The FVCA also conducts research on developments related to sustainable investment and diversity in the venture capital and private equity sector.

Below are links to guidance or templates for venture capital and private equity investors on how to approach a general partner for sustainable investing. These give a good overview of what a general partner must be prepared for when entering into discussions with limited partners.

- An ESG Toolbox, developed as a collaborative effort within the Finnish Venture Capital Association's ESG working group, describing the metrics and frameworks commonly used in the venture capital and private equity sector
- An updated Due Diligence Questionnaire (DDQ) template provided by the Institutional Limited Partner Association (ILPA), including metrics for assessing various aspects related to diversity and environmental, social and governance (ESG)
- The European Commission's sustainable finance web pages
- Invest Europe's web pages on responsible investment