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Insights

CALIFORNIA IMPOSES SWEEPING DEMOGRAPHIC REPORTING RULE ON PRIVATE FUND SPONSORS

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On October 8, 2023, California Governor Gavin Newsom signed into law Senate Bill 54, Fair Investment Practices by Investment Advisers ("**SB54**"). The law requires that "covered entities" collect and report sensitive demographic information about the founding team members of the businesses in which they invest. The law potentially applies to a broad variety of private fund sponsors beyond the venture capital industry and even fund sponsors without a direct nexus to California. The ostensible purpose of the law, per the sponsoring senator's press release, is to "help more women- and minority-owned startups access VC funding."[1]

The law becomes effective March 1, 2025, after which the California Civil Rights Department (the "**Department**") can enforce it through civil actions. Governor Newsom's signing statement acknowledges that the law "contains problematic provisions and unrealistic timelines." The Governor's statement indicates he will propose "cleanup language" in his 2024-25 budget.

WHAT DOES SB54 REQUIRE?

"Covered entities" subject to the law must report information to the Department about their funding activities, including demographic information for the founding teams of all the businesses in which the covered entity made a "venture capital investment" in the prior calendar year. The term "venture capital investment" cross references Section 260.204.9 of the California Code of Regulations (the "**Private Fund Adviser Exemption**") and means:

> *an acquisition of securities in an operating company as to which the investment adviser, the entity advised by the investment adviser, or an affiliated person of either has or obtains management rights[.]*

The information that must be reported includes gender, race, ethnicity, disability, veteran status, and LGBTQ+ identity. To comply, a covered entity must use a survey provided by the Department to collect personal data on each "founding team member" (as discussed below) of a business that has received a venture capital investment from the company.

Failure to comply with SB54's requirements could expose a covered entity to civil enforcement actions and penalties. The size of any penalty will increase commensurate with several statutory factors, namely the size of the covered entity, its assets under management, the nature of the covered entity's failure to comply with SB54, the Department's attorneys' fees, and any other relief that a court deems appropriate.

WHAT IS A "COVERED ENTITY" UNDER SB54?

A "covered entity" means a "venture capital company," as defined under the Private Fund Adviser Exemption, which meets two criteria. We discuss the term "venture capital company" and the two criteria separately:

"Venture Capital Company" means more than venture capital funds

The definition of "venture capital company" under SB54 cross references the Private Fund Adviser Exemption and is broader than the definition of a "venture capital fund" under rule 203(l)-1 under the Investment Advisers Act of 1940, as amended (the "**Advisers Act**").

While the term "venture capital company" picks up "venture capital funds" under the Advisers Act, it also captures any entity that invests at least fifty percent of its assets, valued at cost, in "venture capital investments" or any entity that is a "venture capital operating company" as defined under the Employee Retirement Income Security Act of 1974, as amended ("**ERISA**").

In other words, real estate funds and private equity funds that have sought to qualify for the VCOC exemption to avoid being deemed plan assets under ERISA could find themselves deemed "venture capital companies" for purposes of SB54.

Two additional criteria broaden the reach of SB54

The two specific criteria for a venture capital company to be deemed a "covered entity" appear in Clauses (A) and (B) of the definition of a "covered entity," as follows:

(A) The venture capital company meets either of the following criteria:

i. The venture capital company primarily engages in the business of investing in, or providing financing to, startup, early-stage, or emerging growth companies.

ii. The venture capital company manages assets on behalf of third-party investors, including, but not limited to, investments made on behalf of a state or local retirement or pension system.

(B) The venture capital company meets any of the following criteria:

i. The venture capital company is headquartered in California.

ii. The venture capital company has a significant presence or operational office in California.

iii. The venture capital company makes venture capital investments in businesses that are located in, or have significant operations in, California.

iv. The venture capital company solicits or receives investments from a person who is a resident of California.

The elaboration of the criteria under Clause (A), in our view, is largely superfluous of the definition of a "venture capital company" under the Private Fund Adviser Exemption. Clause (B), however, addresses the jurisdictional nexus to California.

Subclause (B)(iii) captures any venture capital companies, even those not headquartered in California or with a significant presence or operational office in California, so long as they make any venture capital investments in businesses located in, or with significant operations, in California. In other words, if a venture capital company managed by an investment manager with no operations in California makes a venture capital investment in a business headquartered in New York that has a handful of employees in California, the venture capital company would arguably have to request diversity data from the founders of the New York business and any other business in which the venture capital company makes a "venture capital investment."

Subclause (B)(iv) captures any venture capital companies so long as they have investors or have sought investors in California. In other words, if a venture capital company has solicited capital from a single California resident, regardless of whether that California resident invested in the venture capital company and regardless of whether the venture capital company makes an investment in a business with a California nexus, the venture capital company would have to request data from the founders of all of its businesses in which the venture capital company has made a "venture capital investment."

WHO IS A "FOUNDING TEAM MEMBER" WHOSE INFORMATION MUST BE COLLECTED BY A COVERED ENTITY?

Covered entities must collect diversity data from "founding team members," which, as a term, presents a variety of compliance dilemmas for covered entities. A "founding team member" means either of the following:

(A) A person who satisfied all of the following conditions:

i. The person owned initial shares or similar ownership interests of the business;

ii. The person contributed to the concept of, research for, development of, or work performed by the business before initial shares were issued.

iii. The person was not a passive investor in the business;

(B) A person who has been designated as the chief executive officer, president, chief financial officer, or manager of a business, or who has been designated with a role with a similar level of authority as any of those positions.

Under Clause (A), covered entities may wonder if they have fully surveyed all founding team members if a founding team member might not be a shareholder. Under Clause (B), it may not be immediately obvious which employees have roles akin to senior management (but not within senior management). Will the role of Chief Technology Officer qualify?

While SB54 indicates that the Department will provide the form of survey for covered entities to use, it will be incumbent on covered entities to report data to the Department on an aggregate and anonymized basis. The Department has not yet provided guidance on how to report data. SB54 also mandates that covered entities must not "in any way encourage, incentivize, or attempt to influence the decision of a founding team member to participate in the survey . . . ."[2] An underlying question of SB54's effectiveness is how valuable the data will be if founding team members largely choose not to respond to the survey.

SB54 makes clear the Department may examine the records of a covered entity to determine their compliance with the protocols of SB54 and may assess fees from covered entities to cover the Department's costs in administering SB54.[3]

WILL SB54 PRODUCE USEFUL DATA?

In an August 2023 letter, the National Venture Capital Association (NVCA) strongly urged Senator Nancy Skinner to reconsider the law.[4]The NVCA letter alleges that, due to SB54's failure to incorporate fundamental data science methodologies, the law ultimately would "produce misleading and counterproductive data that would hurt the cause of diversity, equity, and inclusion (DEI) efforts while creating unnecessary costs and risks for California venture capitalists." The NVCA letter also expresses concerns on the potential costs to the venture capital industry, including the threat of punitive action by the Department, and violations to privacy.

Particularly salient about the NVCA letter is its expressed concern that efforts at data anonymization will be unfeasible for both the Department and the private fund sponsors:

> *[S]cenarios will arise where the data provided through a VC investor or a VC fund will be of such small scale that achieving effective anonymization becomes challenging, if not unfeasible. The bill will place both the Department and VC investors in an uncomfortable position, unintentionally risking the exposure of personal information of specific startups and individual founders. Given that many VC funds engage in limited investments within a calendar year, there will be minimal submissions to the State, and the data's susceptibility to manipulation becomes heightened. This manipulation could potentially link private*

demographic information to the startup founding teams through their association with VC funds, thereby infringing upon their personal privacy.

If the NVCA is correct in its concern, compliance with SB54, as drafted, would be ineffective in advancing its ostensible purposes while also potentially causing the Department and private actors to violate privacy laws both within the United States and abroad.

CONCLUSION

SB54 could be challenged in the courts, given the reasonable possibility that SB54 will fail to fulfill its ostensible purposes, its sweeping coverage of fund sponsors beyond the venture capital industry, its dragooning of fund sponsors without a real nexus to California, and significant privacy concerns. We will be closely following developments with respect to SB54.

FOOTNOTES

[1] See Investment In Women- And Minority-Owned Startups Wins Approval From CA Legislature, State Senator Nancy Skinner (September 13, 2023).

[2] See SB54, Cal. Bus. Prof. § 22949.85(b)(2)(e).

[3] See SB54, Cal. Bus. Prof. § 22949.85(b)(2)(e)(3).

[4] National Venture Capital Association, Letter to the Honorable Nancy Skinner re: SB 54 (August 28, 2023).

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