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Insights

CALIFORNIA AMENDS ITS SWEEPING VENTURE CAPITAL DEMOGRAPHIC REPORTING RULE

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Last year, as we previously reported, California Governor Newsom signed into law Senate Bill 54, Fair Investment Practices by Investment Advisers, which requires "covered entities," defined as a "venture capital company" that meets specific criteria, to collect and report sensitive demographic information about the founding team members of the businesses in which they invest. In signing that law, the Governor acknowledged that the law "contains problematic provisions and unrealistic timelines" and indicated that "cleanup language" would be proposed.

This year, the Governor enacted Senate Bill 164, "Fair Investment Practices by Venture Capital Companies" which provided for that cleanup language. Senate Bill 164 repeals and replaces Senate Bill 54, but the purpose of the law and much of the language remains the same. Senate Bill 164 amends the law in the following material respects:

- California's Department of Financial Protection and Innovation (the "Department") will now oversee the law instead of the Civil Rights Department.
- The law has narrowed the definition of "covered entities" subject to reporting so that the law will apply generally to venture capital funds. The prior definition of "covered entities" arguably picked up a broad variety of private funds beyond the venture capital industry. While the definition of "covered entities" has been narrowed, the law continues to retain vague language that could pick up investment vehicles focusing on secondary investments in privately held businesses or that otherwise have a mixed investment strategy that includes venture capital investing.
- The compliance reporting date has moved from March 1, 2025 to April 1, 2026. We would note that the Department has not yet prepared the prescribed form for reporting.
- The definition of "founding team member" for which reporting is required has been limited to officers that are designated as either the chief executive officer or president. The prior law also picked up CFOs and other managers with a similar level of authority as a CEO, President or CFO.

- Record retention requirements have increased from four to five years.
- Further elaboration has been provided as to Department's investigative powers with respect to compliance of the law and penalties for non-compliance, including that penalties could be as much as $5,000 for each day that a violation or failure to pay imposed by the department continues.
- The Commissioner has been given numerous powers including that it may:
  - require a covered entity to produce documentary material for inspection and copying or reproducing in the form or medium requested by the Department or file written reports or answers to questions;
  - make public or private investigations within or outside this state as it deems necessary to determine whether a covered entity has violated or is about to violate any provision of this law; or
  - publish information concerning any violation of this law.
- The fee per report have been set at "at least one hundred seventy-five dollars" and the department may adjust this fee as necessary to meet the reasonable costs of administration.

While many fund sponsors may take some relief in the narrowing of the definition of "covered entities," the law continues to include a variety of problematic provisions that could expose it to legal challenge:

Jurisdictional Nexus

The law 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." Additionally, the law 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."

Lack of Guidance on How to Report

The law makes clear that covered entities must report data to the Department on an aggregate and anonymized basis. The Department has not yet provided guidance on how to do so. Moreover, the law 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 . . . ." However, given the sensitive nature of the information to be sought, it is not implausible that many founding team members may refuse to respond. If this were to happen, how would the Department address covered entities that cannot satisfy their compliance obligations under the law? How would the Department's aggregation of data even be useful for the purpose of "help[ing] more women- and minority-owned startups access VC funding"[1]?

Will the Law Produce Useful Data?

In an August 2023 letter, the National Venture Capital Association (NVCA) strongly urged Senator Nancy Skinner to reconsider the law.[2]The NVCA letter alleges that, due to the law'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 the law 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.

Reporting is for the prior calendar year

While the law does not go into effect until April 1, 2026, covered entities should be aware that the law requires reporting of information for the founding teams of all the businesses in which the

covered entity made a venture capital investment in the prior calendar year. This means that covered entities will have to report the founding teams of the businesses in which they make a venture capital investment in 2025.

Conclusion

We continue to believe that this law will be challenged in the courts, given the plausibility that the law will fail to fulfill its ostensible purposes, its sweeping coverage of fund sponsors, its dragooning of fund sponsors without a real nexus to California, its onerous penalties and significant privacy concerns.

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

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

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