California’s New VC Diversity Reporting Law Aims to Increase Transparency

Venture capital firms should begin planning now for compliance to avoid monetary penalties or court action.

California Governor Gavin Newsom signed Senate Bill No. 54 (SB 54) into law on October 8, 2023. The bill is designed to increase transparency in the state’s venture capital industry, and signals California’s continued attention to diversity matters. However, the law takes a disclosure-focused approach instead of substantive, conduct-based requirements which were used in previous laws that were successfully challenged. SB 54 will require “covered entities” to annually (a) collect diversity statistics regarding the founding teams of their portfolio companies and (b) report these statistics to the California Civil Rights Department (CRD), who will in turn make the reports available to the public on the CRD website. The first report due on March 1, 2025 (with reports for subsequent years due annually thereafter) will disclose the required information for the 2024 calendar year.

Covered Entities

SB 54 applies to covered entities, which means “venture capital companies,” as defined in 10 CCR 260.204.9 (which includes, but is not limited to, “venture capital funds” and “venture capital operating companies), that meet two criteria."

First, the venture capital company must either be (i) primarily engaged in the business of investing in, or providing financing to, startup, early-stage, or emerging growth companies, or (ii) managing assets on behalf of third-party investors.

Second, the venture capital company must have a California nexus, which is satisfied if the venture capital company: (i) is headquartered in California; (ii) has a significant presence or operational office in California; (iii) makes venture capital investments in businesses that are located in, or have significant operations in, California; or (iv) solicits or receives investments from a person who is a resident of California.

Required Reporting

SB 54 requires a covered entity to report the following information to the CRD:

- an aggregated report on certain characteristics of the “founding team members” of all businesses in which the covered entity made a venture capital investment in the prior year, including (1) gender...
identity, (2) race, (3) ethnicity, (4) disability status, (5) LGBTQ+ identity, (6) veteran/disabled veteran status, (7) California residency status, and (8) whether any member declined to provide any of this information;

• the number of venture capital investments to businesses primarily founded by “diverse founding team members,” as a percentage of total venture capital investments the covered entity made, both in aggregate and for each of categories 1-6 above;

• the total amount of venture capital investments to businesses primarily founded by “diverse founding team members,” as a percentage of venture capital investments the covered entity made, both in aggregate and for each of categories 1-6 above;

• the total amount of money in venture capital investments the covered entity invested in each business during the prior calendar year; and

• the principal place of business of each company in which the covered entity made a venture capital investment during the prior calendar year.

These reports will be made publicly available on the California Civil Rights Department’s website, and SB 54 expressly contemplates that the information may be used in the furtherance of the department’s statutory duties, including potential civil actions.

Surveying

Covered entities must collect the required founding team member information using a standardized demographic survey that will be established by the CRD, and the survey must be distributed to the founding team members after the covered entity’s investment is completed (i.e., the survey cannot be included in any preliminary research or diligence requests).

The standardized surveys must include a “decline to state” box for each question in the survey, and covered entities are required to inform founding team members in writing that (a) participating in the survey is fully voluntary, (b) there are no consequences if a team member does not complete the survey, and (c) the data collected for each demographic category will be aggregated and disclosed to the CRD. Covered entities are expressly prohibited from encouraging founding team members to participate in the survey.

Covered entities are required to implement systems to ensure that survey responses are not associated with any specific founding team member, and they must preserve records relating to the surveys collected and information reported to the CRD for at least four years following the filing of such reports.

Noncompliance

Failure to report under SB 54 will initially result in a notification from the California Civil Rights Department regarding the requirement; within 60 days from such notification the covered entity must submit the required report. If a report is still not submitted within that time frame, the department may pursue an enforcement action for injunctive relief as well as penalties to be determined in relation to the size of the entity, its assets under management, and the nature of the failure to comply.
Effective Date; Potential Revisions

As described above, SB 54 requires that a covered entity file its first report with the CRD by March 1, 2025, with reports annually thereafter, covering information from the prior year. As such, venture capital companies in-scope of this law may need to begin collecting this data as soon as 2024 and will need to determine their processes for complying with these new requirements. However, when signing the bill, Governor Newsom noted that “this bill contains problematic provisions and unrealistic timelines that could present barriers to successful implementation and enforcement,” and that his administration will “propose cleanup language … to ensure that the new law can be implemented properly.”

Accordingly, we expect further guidance from the Governor’s office as the parties discuss implementation of SB 54. This may result in revisions to the statute or potential delays to the initial reporting date. In addition, as with California’s previous diversity-related laws, SB 54 will likely face legal challenges. However, this new bill has significant differences in approach which may make SB 54 more difficult for a potential plaintiff to overcome, including a focus on disclosure and the ultimately voluntary nature of individual team member’s reporting of such information. Covered entities should therefore begin planning for compliance with the new law and pay close attention to any responses to the bill, including not only litigation but also any regulations or guidance published by California’s Civil Rights Department, so as to be positioned to comply with the requirements to the extent they continue in place.

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Endnotes

1 10 CCR 260.204.9 defines a “venture capital company” as an entity that satisfies one or more of the following:
   “(a) on at least one occasion during the annual period commencing with the date of its initial capitalization, and on at least one occasion during each annual period thereafter, at least fifty percent (50%) of its assets (other than short-term investments pending long-term commitment or distribution to investors), valued at cost, are venture capital investments, as defined in subsection (a)(5) of this rule, or derivative investments, as defined in subsection (a)(6) of this rule;
   (b) the entity is a “venture capital fund” as defined in rule 203(l)-1 adopted by the Securities and Exchange Commission under the Investment Advisers Act of 1940, as amended (17 C.F.R. 275.203(l)-1); or
   (c) the entity is a “venture capital operating company” as defined in rule 2510.3-101(d) adopted by the U.S. Department of Labor under the Employee Retirement Income Security Act of 1974 (29 C.F.R. § 2510.3-101(d)).”

2 SB 54 defines a “founding team member” as someone who either (1) owned initial ownership interests in the business, was not a passive investor, and contributed to the concept/research/development of the business prior to the issuance of initial shareholders or (2) has been designated as chief executive officer, president, chief financial officer, business manager, or another role with a similar level of authority as any of those positions.

3 SB 54 defines a “diverse founding team member” as a founding team member “who self-identifies as a woman, nonbinary, Black, African American, Hispanic, Latino-Latina, Asian, Pacific Islander, Native American, Native Hawaiian, Alaskan Native, disabled, veteran or disabled veteran, lesbian, gay, bisexual, transgender, or queer.”