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California Adopts New Law Requiring VC Companies to Collect Diversity Data From Portfolio Company Founders

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California's governor recently signed into law SB 54, a bill intended to increase transparency regarding diversity of founding teams in the venture capital (VC) industry. The new law will require VC companies, including "venture capital funds" (as defined in the Investment Advisers Act of 1940), with a nexus to California to report to the California Civil Rights Department (CRD) on the diversity of the founding members of companies in which they invest.

Overview

SB 54 will require "covered entities" to collect and maintain diversity data about the founding teams of their portfolio companies and report such information to the CRD on an annual basis. While the bill includes March 1, 2025, as the first reporting date, we expect this may get pushed back due to some comments from Gov. Gavin Newsom and possible litigation challenges, as discussed below.

Covered entities

As defined in the bill, the term "covered entity" means a VC company that meets two requirements. First, the VC company must either primarily engage in the business of investing in, or providing financing to, startup, early-stage or emerging growth companies, or manage 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. Second, the VC company must have a nexus to California meeting any of the below criteria.

The VC company:

- Is headquartered in California.
- Has a significant presence or operational office in California.
- Makes venture capital investments in businesses that are located, or have significant operations, in California.
- Solicits or receives investments from a person who is a resident of California.

Reporting requirements

SB 54 requires covered entities to survey the founding team members of portfolio companies they have invested in over the prior calendar year and report the following to the CRD on an annual basis:

Founding team demographic data

A covered entity must report the following demographic information for the founding teams of all portfolio companies in which the covered entity invested in the prior calendar year (to the extent the information was provided pursuant to the survey described below): gender identity, including nonbinary and gender-fluid identities, race, ethnic identity, disability status, veteran status, whether such person identifies as LGBTQ+ and whether such person is a California resident, at an aggregated level and on an anonymized basis.

Investment in diverse founding teams data

Covered entities also must report the total amount of investments in the prior calendar year in portfolio companies that were primarily founded by diverse founding teams (i.e., where at least half of the founding team is made up of people of diverse backgrounds and perspectives), as a percentage of venture capital investments

made by the covered entity, in the aggregate and broken down according to the demographic categories listed above, as well as the total amount of money in venture capital investments the covered entity invested in each portfolio company during the prior calendar year and the principal place of business of each portfolio company in which the covered entity made an investment during the prior calendar year.

The CRD may publish this information on its website and is charged with enforcing the new law. Failure to comply could result in a court action brought by the CRD and/or financial penalties.

Demographic survey

Covered entities will be required to collect founding team member demographic data through a standardized survey that will be established by the CRD. The survey must be delivered to founding team members after the covered entity's investment is completed – i.e., the survey cannot be included as part of the covered entity's pre-investment diligence. Founding team members can decline to participate in the survey, and covered entities are required to provide written notice in connection with the survey that such founding team member's decision to disclose their demographic information is voluntary, that no adverse action will be taken against the founding team member if they decline to participate in the survey, and that aggregate data collected for each demographic category will be reported to the CRD. Survey results must be collected and reported in a manner that does not associate the survey response data with individual founding team members, and the covered entity must preserve data for at least four years after the report is delivered.

Timeline and potential changes

As it currently stands, the first report will be due on March 1, 2025. However, we expect additional guidance and clarification from the CRD and the governor's office in the coming months, and it is possible (if not likely) that this timeline will be delayed. In his letter on signing the bill, Newsom said the 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 this important policy to improve the diversity of venture capital investments can be implemented properly." We also expect the statute may be subject to legal challenges that could delay implementation. We are monitoring this new law and will keep clients updated on developments as they arise.

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