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Family Office Insights

"Fair Investment Practices by Investment Advisers" California's New Law Seeks to Increase Transparency of Private Fund Investments in California

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Overview

On October 8, 2023, California's Governor, Gavin Newsom, signed the "Fair Investment Practices by Investment Advisers" law (SB54), that will require certain "venture capital companies" (broadly defined to include venture capital firms, private equity firms and family offices) with sufficient nexus to California to report demographic information to California's Civil Rights Department (CRD), with respect to the founding members of their portfolio companies.

According to Governor Newsom, SB54's purpose is to address the characteristically sparse and inequitable distribution of funding by venture capital firms to emerging companies that are owned, founded and/or operated by traditionally underrepresented groups, including women and minorities, and to consequently provide economic empowerment to such underrepresented groups.

Due to SB54's broad characterization of "venture capital companies," family offices should keep abreast of the latest developments with SB54 (regulatory, amendments, or legal challenges) as we come closer to SB54's first compliance date of March 1, 2025.

When Does a "Covered Entity" Need to Comply with the Requirements of SB54?

Pending any challenges to the law, initial reports must be filed by "covered entities" by March 1, 2025, with respect to investments made in the 2024 calendar year.

Are You a "Covered Entity"?

Under this law, a "Covered Entity" is an entity that (1) is a "venture capital company," or "VCC" (which, as discussed below, is a term that is broadly defined under this law) and, (2) such a VCC meets two requirements – first, the VCC has a "sufficient nexus" to California (as discussed below) and second, the VCC primarily invests in or provides financing to emerging companies, or it manages assets on behalf of third-party investors.

As a threshold matter, one needs to determine if the entity is a VCC under SB54. Under SB54, a "VCC" is broadly defined as an entity meeting at least one of the following:

(i) An entity that has, at least once during the annual period commencing with the date of its initial capitalization, and on at least once during each annual period thereafter, at least fifty percent (50%) of its assets from its venture capital investments (i.e., acquisition of securities in which it also obtains management rights);

(ii) A "venture capital fund" as defined in Rule 203(l)-1 under the Investment Advisers Act of 1940 in the US,

or

(iii) A "venture capital operating company" as defined in Rule 2510.3-101(d) under the Employee Retirement Income Security Act of 1974 in the US.

While the law attempts to focus on traditional venture capital firms, the currently broad definition of VCC appears to capture other types of investing entities, including private equity funds and family offices.

If your entity is a VCC, then the analysis turns to whether you meet two conditions – (1) a geographic nexus condition – does the VCC have a "sufficient nexus" to California; and (2) an operational requirement – does the VCC primarily invest in or provide financing to emerging companies, or does it manage assets on behalf of third-party investors. If a VCC meets these two criteria, then it is a "Covered Entity" under SB54 subject to the reporting requirements of the law.

A VCC has "sufficient nexus" to California if it satisfies any of the following:

(i) It is headquartered in California;

(ii) It has a significant presence or an operational office in California;

(iii) It makes venture capital investments in businesses located in, or that have significant operations in, California;

or

(iv) It solicits or receives investments from a person who is a resident of California.

As for the operational requirement, a VCC meets this requirement if at least one of the following two criteria exists:

(i) It primarily engages in the business of investing in, or providing financing to, startup, early-stage or emerging growth companies;

or

(ii) It 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.

What Information Must Be Reported to the CRD?

Covered Entities must report to the CRD certain diversity information concerning the "founding team members" of all the companies in which they have made venture capital investments in the prior year (Invested Companies). Such diversity information includes the founding team member's gender identity, race, ethnicity and disability, as well as whether the founding team member (i) identifies as LGBTQ+, (ii) is a veteran or disabled veteran, (iii) is a resident of California or (iv) declined to provide such information to the Covered Entity. Under SB54, Covered Entities are instructed to collect the requested information by providing each "founding team member" of an Invested Company with a voluntary survey to be determined by the CRD. As of the date of this alert, the CRD has not yet published the form of the voluntary survey.

The completion of the survey by a "founding team member" is entirely voluntary, and no adverse action may be made against them for their refusal to participate in the survey or to provide the requested information. In addition, the Covered Entity must collect the survey data and report such data to the CRD in an anonymous manner, so that the information cannot be associated with a particular founding team member.

Covered Entities must report to the CRD, at an aggregated level, the requested demographic information of the "founding team members" to the extent the information is collected via the CRD's survey. A "founding team member" is defined as either of the following:

(i) A person satisfying all of the following:

(a) Person owned initial shares or similar ownership interests of a business

(b) Person contributed to the concept of, research for, development of or work performed by a business before initial shares were issued

(c) Person was not a passive investor in a business

or

(ii) A person designated as the CEO, president, CFO, manager or similar position of a business.

In addition to the demographic information of "founding team members," SB54 also requires Covered Entities to report the total number and dollar amount of venture capital investments in Invested Companies primarily founded by "diverse founding team members," and also as a percentage of the total number and dollar amount of venture capital investments made by the Covered Entity in the same period. A company is primarily founded by "diverse founding team members" if more than one-half (1/2) of the founding team members respond to a SB54 survey, and at least one-half (1/2) of the founding team members are diverse founding team members. "Diverse founding team members" refers to founding team members self-identifying 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.

What Will the CRD Do with the Information Disclosed by a Covered Entity?

Following receipt of the SB54 reports, the CRD may publish, on an aggregated basis, and make available reported information to the public. The CRD may also use such reported information in furtherance of its statutory duties. In the law's current form, however, SB54 provides no further guidance as to how reported information may be used by the CRD, and the CRD has not yet issued any regulations regarding this matter at this time.

Covered Entities will also be obligated to keep records relating to its SB54 reporting obligations for at least four (4) years following submission of a report to the CRD. During this period, the CRD may examine such records to determine compliance.

What Are the Penalties for Failing to Report to the CRD?

Under the law, California's CRD will be given the authority to implement and enforce SB54, and to conduct extensive investigations to determine compliance.

If Covered Entities fail to report by March 1 of a given year, then the CRD shall notify the Covered Entity and allow it sixty (60) days to submit a report. If this sixty (60)-day remedial period elapses without a report having been submitted, then the CRD may exercise a variety of remedies, including filing an ex parte petition with a California superior court against the violating party to seek compliance, seek financial penalties against the Covered Entity sufficient to deter future violations, seek recovery of the CRD's reasonable attorney's fees and costs incurred and/or seek any other relief deemed appropriate by a court.

Conclusion

While SB54 does not mandate diversity requirements for Investment Companies of Covered Entities, the law's purpose of increasing the transparency of the diversity backgrounds of emerging growth companies will prove challenging in practice for many investment firms. In its current form, this new legislative action provides more "questions than answers" and will require clear directives from the CRD to enable firms to meet SB54's disclosure obligations. In signing the bill into law, Governor Newsom admitted that the legislation contained certain "problematic provisions with unrealistic timelines," so how this new law will operate in practice is still to be determined. As of the date of this alert, the CRD has not yet issued any regulations with respect to SB54. Thus, family offices and other investment firms will need to pay close attention to any new regulations from the CRD in the coming year (and/or legal challenges to SB54) before the first compliance due date on March 1, 2025.

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