SENATE JUDICIARY COMMITTEE
Senator Thomas Umberg, Chair
2023-2024 Regular Session

SB 54 (Skinner)
Version: April 17, 2023
Hearing Date: April 25, 2023
Fiscal: Yes
Urgency: No
AWM

SUBJECT

Investment advisers: reporting.

DIGEST

This bill requires a person who acts as an investment adviser to a venture capital company, as defined, beginning March 1, 2025, to submit an annual report to the Department of Financial Protection and Innovation (DFPI) on their venture capital investments made in companies primarily founded by diverse founding team members, as specified.

EXECUTIVE SUMMARY

Venture capital firms make equity investments in private businesses that they intend to liquidate when the business goes public or seeks a larger subsequent round of private investment. In addition to investing capital, venture capital firms often provide managerial, technical, and financial expertise to the companies in which they invest. As such, access to venture capital can be the difference in whether a new business sinks or swims.

In California, venture capital investments do not reflect the state's diversity. According to the author's office, companies founded or co-founded by women receive far less investment funds from venture capital funds than companies founded by men, and companies founded or co-founded by people of color receive far less investment funds than companies founded or co-founded by white people. Stakeholders assert that the discrepancy in investments is due to conscious and unconscious bias, not the merit of the investments.

This bill requires investment advisers making venture capital investments to annually report, beginning in 2025, to the DFPI about their investments made to businesses with diverse founding teams in the prior year. The author and sponsors believe that greater transparency will drive change that creates greater equity in investing. The bill is modeled after a similar requirement for insurance companies doing business in California to report on the diversity of their governing boards. The author has agreed to certain amendments to clarify certain terms and add an additional reporting requirement for founding team members who are veterans or disabled veterans.

This bill is sponsored by the F5 Collective and is supported by Pyrium and Scroobius Inc. There is no known opposition. The Senate Banking and Financial Institutions Committee passed this bill with a vote of 5-1.

PROPOSED CHANGES TO THE LAW

Existing law:

1) Requires the State Bar to develop and implement a plan to meet specified diversity goals and submit a biannual report to the Legislature setting forth the plan, its implementation, the outcomes, and the effectiveness of the measures taken. (Bus. & Prof. Code, § 6001.3.)

2) Requires the California State Teachers' Retirement System (CalSTRS) and the California Public Employees' Retirement System (CalPERS) to each produce and submit an annual report on the participation of emerging managers or diverse managers under contract with each respective fund to manage pension fund assets.
   a) The terms "emerging managers" and "diverse managers" are to be defined by the systems' respective boards.
   b) This requirement is set to sunset on January 1, 2028. (Ed. Code, § 22228; Gov. Code, § 20136.)

3) Requires the Governor to release, on an aggregated statewide basis, demographic data provided by judicial applicants, judicial appointees, and judicial nominees, including, where provided, data relative to race, ethnicity, disability, veteran status, gender, gender identity, and sexual orientation; and the State Bar to release the same information relating to judicial applicants reviewed and the statewide summary of the recommendations by those specified categories. (Gov. Code, § 12011.5(n).)

4) Requires a licensed hospital with operating expenses of $50,000,000 or more and each licensed hospital with operating expenses of $25,000,000 or more that is part of a hospital system to submit a report to the Office of Statewide Health Planning and Development setting forth its minority, women, LGBT, and disabled veteran business enterprise procurement efforts, as specified, during the previous year. The Office shall provide public access to the reports on its website. Failure to comply subjects the hospital to a $100/day civil penalty. (Health and Safety Code, div. 2, ch. 2.17, §§ 1339.85 et seq.)

5) Requires insurance companies with California premiums written of $75,000,000 or more to, on a biannual basis, report to the Insurance Commissioner:
   a) The company's minority, women, LGBT, veteran, and disabled-veteran-owned business procurement efforts during the previous two years, as specified; failure to report the information subjects the insurer to a civil penalty of up to $5,000, or up to $10,000 if the failure was willful.
   b) The company's governing board and diversity efforts, as defined; the insurer must notify board members that the decision to disclose demographic information is voluntary and no adverse action may be taken if a board member declines to participate in the survey.
   c) The Insurance Commissioner must, by November 1 of the reporting year, establish and maintain a link on the department's website that provides public access to the contents of the reported information; information provided pursuant to (b) must be published in the aggregate and shall not identify an individual respondent or insurer. (Ins. Code, div. 1, pt. 2, ch. 1, art. 10.2, §§ 927 et seq.)

6) Makes it unlawful for any investment adviser to conduct business as an investment adviser in this state unless the investment adviser has first obtained a certificate from the commissioner of the DFPI, unless exempt from the certification requirement as specified. (Corp. Code, § 25230.)

This bill:

1) Makes findings and declarations regarding the lack of diversity among recipients of venture capital investments.

2) Defines the following relevant terms:
   a) "Covered person" means a person that (1) acts as an investment adviser to a venture capital company, and (2) is a registered or exempt investment adviser, as specified.
   b) Diverse founding team member" means 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, veteran or disabled veteran, lesbian, gay, bisexual, transgender, or queer.
   c))"Founding team member" means either of the following:
      i. A person who owns initial shares or similar ownership interests of a business and played a significant role in conceiving, developing, or establishing the business prior to the initial shares being issued; or
      ii. A person who has been designated as the chief executive officer, president, or chief financial officer of a business.

  d) "Venture capital company" and "venture capital investment" have the same meaning as defined in Section 260.204.9 of Title 10 of the California Code of Regulations.

3) Requires a covered person, beginning March 1, 2025, to submit, on an annual basis, a report to DFPI that includes all of the following information about its funding determinations:
   a) At an aggregated level, all of the following information for the founding teams of all of the businesses in which the covered person made a venture capital investment in the prior calendar year to the extent the information was provided pursuant to the survey described 4):
      i. The gender identity of each member of the founding team, including nonbinary and gender fluid identities.
      ii. The race of each member of the founding team.
      iii. The ethnicity of each member of the founding team.
      iv. The disability status of each member of the founding team.
      v. Whether any member of the founding team identifies as LGBTQ+.
      vi. Whether any member of the founding team declined to provide any of the information described in (i)-(v).
   b) During the prior calendar year, the total amount funded to businesses primarily founded by diverse founding team members, as a percentage of the total number of venture capital investments the covered person made, in the aggregate and broken down into the categories described in (i)-(v). The information shall be anonymized.
   c) During the prior calendar year, the total amount funded to businesses primarily founded by diverse founding team members, as a percentage of the total amount of money invested by the covered person, in the aggregate and broken down into the categories described in clauses (i)-(v).

4) Requires the covered person to obtain the information required under 3) by providing each founding team member of a business that has received funding from a venture capital company to which the covered person has acted as an investment adviser with an opportunity to participate in a survey for the purpose of collecting the information.
   a) The survey shall be provided pursuant to a standardized form specified by the DFPI. The survey shall include a "decline to state" option for each question on the survey.
   b) A covered person shall provide a written disclosure to each founding team member prior to, or concurrently with, the survey that states all of the following:
      i. The founding team member's decision to disclose their demographic information is voluntary.
      ii. No adverse will be taken against the founding team member if they decline to participate in the survey.

iii. The aggregate data collected for each demographic category will be reported to the department.

5) Provides that a covered person shall not provide the survey and disclosure in 4) to a founding team member until after the covered person has executed an investment agreement with the business and made the first transfer of funds.

6) Provides that neither a covered person nor the DFPI shall in any way encourage, incentivize, or attempt to influence the decision of a founding team member to participate in the survey in 4).

7) Requires a covered person to do both of the following in connection with the survey in 4):
   a) Collect survey response data from the founding team members in a manner that does not associate the survey response data with an individual founding team member.
   b) Report the survey response data in a manner that does not associate the survey response data with an individual founding team member.

8) Provides that a covered person may satisfy the requirements of 3) by providing a report prepared by a business that controls each venture capital company to which the covered person acted as an investment adviser at any time during the prior calendar year if the report contains all of the required information.

9) Requires the DFPI to make the reports received under 3) readily accessible, easily searchable, and easily downloadable on its website.

10) Provides that, except as required in 9), the information collected pursuant to 3)-4) is confidential and shall not be released by the DFPI or a covered person under any circumstances.

11) Requires a covered person to make and keep records related to its obligations under 3)-9), and preserve the records for at least four years after the covered person delivers a report to the DFPI.

12) Permits the DFPI to examine the records of a covered person to determine its compliance with the requirements of 3)-9), and to charge a fee to cover the expenses incurred in the administration of 3)-9), in an amount to be determined.

13) Provides that, if a covered person fails to file a report required in 3) by March 1 of a given year, the DFPI shall notify the covered person that the covered person must submit the report within 60 days of the notification. If the covered person has not submitted the report after those 60 days have elapsed, the commissioner shall charge

and collect a penalty of $100,000, the proceeds of which shall be deposited in the Financial Protection Fund.

14) Finds that the information collected pursuant to 3)-4) is exempt from public disclosure, except as provided, because of the need to protect the privacy of the individuals whose data is being collected.

COMMENTS

1. Author's comment

According to the author:

> The persistent lack of investment in women-owned and certain minority-owned businesses by the venture capital (VC) ecosystem is a matter of growing concern. While awareness of the importance of diversity and inclusion has increased in recent years, the proportion of capital invested in woman-founded and Black and Latino start-ups remains disappointingly low. Woman founded start-ups received only 2.3% of all venture capital investments in 2020 and this number decreased to 1.7% in 2022. Venture capital firms themselves are dominated by men, particularly white men. Figures for 2022 indicate that 91% of the decision makers in venture capital firms are men. The lack of diversity in investment decisions limits opportunities for women and minorities to access capital for their entrepreneurial businesses. Businesses with diverse leadership teams bring a broader range of viewpoints and studies reveal that companies with diverse leadership often outperform their less diverse peers in terms of financial performance. Investing in women and minority-owned and co-founded businesses allows companies to better understand and serve the needs of a diverse customer base, tapping into unexplored market opportunities.
>
> To address the lack of investment in women owned and minority owned businesses, SB 54 mandates that institutional investors report statistics on racial, gender, and other characteristics of the founders of companies in which they invest. Such transparency has the potential to drive change in the financial ecosystem which will not only create greater equity in investing, but will increase innovation in business.
>
> This bill represents a critical step towards ensuring that women entrepreneurs and entrepreneurs from under-represented communities receive the support and resources they deserve, ultimately benefiting the economy and society as a whole.

2. Diversity in venture capital (or not)

The analysis of the Senate Banking and Financial Institutions Committee, incorporated here by reference, explained venture capital as follows:

> Venture capital refers to a category of investment that focuses on early stage businesses that show potential for significant growth. Venture capital funds (VCs) are typically private funds that are available only to a limited set of institutional investors, such as pensions, college endowments, trusts, insurance companies, health care systems, high net worth individuals, family offices, and sovereign wealth funds. VCs make equity investments in private businesses that they intend to liquidate when the business goes public or seeks a larger subsequent round of private investment. In addition to investing capital, VCs often provide managerial, technical, and financial expertise to the companies in which they invest. Because of the early stage nature of this category, many VC investments do not generate a profit for investors as many start-up businesses fail; however, a small number of investments generate very large returns on capital, which allows the industry to stay viable.

Yet the world of venture capital is remarkably lacking in diversity. A 2021 report on diversity in venture capital firms found that women made up about 24 percent of the investment workforce, and Black and Hispanic investment professionals constituted 4 percent of the workforce each.[1] The lack of diversity is also present in the companies in which venture capital investments are made: in 2020, 2.3 percent of venture capital funding went to women-led startups;[2] investment in startups with Black founders has fluctuated between 1.8 and 2.5 percent of all venture capital investments,[3] with Black women receiving a meager .27 percent—just over a quarter of one percent—of all United States venture capital investment dollars since 2018.[4]

This disparity in access to VC funds cannot be explained away as the result of the quality of the investments being offered: one study found that businesses founded by women ultimately deliver more than twice as much per dollar invested than male-

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[1] NCVA, Venture Forward, & Deloitte, VC Human Capital Survey (3d ed. 2021), pp. 5, 7, 10.

[2] Bittner & Lau, *Women-Led Startups Received Just 2.3% of VC Funding in 2020*, Harvard Business Review (Feb. 25, 2021), https://hbr.org/2021/02/women-led-startups-received-just-2-3-of-vc-funding-in-2020. All links in this analysis are current as of April 20, 2023.

[3] Teare, *VC Funding To Black-Founded Startups Slows Dramatically As Venture Investors Pull Back*, Crunchbase News (Jun. 17, 2022), https://news.crunchbase.com/diversity/vc-funding-black-founded-startups/.

[4] Knickerbocker, *82 Black founders and investors to watch in 2023*, PitchBook blog (Feb. 3, 2023), https://pitchbook.com/blog/black-founders-and-investors-to-watch.

founded firms.[5] Studies have also shown that companies with higher-than-average ethnic and gender diversity are more likely to have above-average profitability.[6]

Investors often trumpet their commitments to diversity as a selling point. For example, in 2020, in the wake of the national outcry over the murder of George Floyd, numerous venture capital firms pledged to invest more in businesses led by entrepreneurs of color.[7] But the public has no easy way to determine which firms are living up to their promises.

3. <u>This bill requires institutional investors with a nexus to California to report on specified demographic information regarding the founding teams of the businesses in which they make venture capital investments</u>

This bill requires investment advisers who make venture capital investments to annually report to the DFPI information regarding diversity of the businesses to which they provide venture capital. Specifically, each adviser must file a report setting forth:

1. The gender identity, race, ethnicity, disability status, and LGBTQ+ status of the members of the founding teams in which they make investments, provided at an aggregated level.
2. The total amount funded to businesses primarily founded by diverse founding team members in the prior calendar year, as a percentage of the total number of venture capital investments the covered person made, in the aggregate and broken down into the categories described in (1), provided on an anonymized basis.
3. The total amount funded to businesses primarily founded by diverse founding team members during the prior calendar year, as a percentage of the total amount of money invested by the covered person, in the aggregate and broken down into the categories described in (1).

The author has agreed to amendments to clarify who constitutes a founding team member and when a business is "primarily founded" by diverse founding team members, as well as to add reporting requirements for founding team members who are veterans or disabled veterans; these amendments are discussed below in Part 5.

The investment adviser must collect the information on the founding teams through a survey, which can be provided to founding team members only after the venture capital investment agreement has been executed and the first funds transfer has been made. The survey must be in a form specified by the DFPI and must include a "decline to

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[5] Abouzahr et al., *Why Women-Owned Startups Are a Better Bet* (Jun. 6, 2018) https://www.bcg.com/publications/2018/why-women-owned-startups-are-better-bet.
[6] Fyle et al., *Diversity Wins*, McKinsey & Co. (May 19, 2020), https://www.mckinsey.com/featured-insights/diversity-and-inclusion/diversity-wins-how-inclusion-matters.
[7] Padres, *VC Pledged to 'Do Better' on Diversity. It's Barely Changed*, Wired (Jun. 10, 2021), https://www.wired.com/story/vc-pledged-better-diversity-its-barely-changed/.

state" option for each question; the investment adviser must also collect the information in a way that does not associate the survey response data with any particular founding team member. The survey must be accompanied by a disclosure that explains that the decision to disclose demographic information is voluntary and that no adverse action may be taken against a founding team member who declines to participate.

If an institutional investor fails to comply with the reporting requirement, the investor shall be liable for a civil penalty of $100,000 per report, which can be assessed in an administrative proceeding brought by the DFPI. The bill requires DFPI to make the reports easily accessible, easily searchable, and easily downloadable on its website.

According to the author and sponsors, these public disclosures will provide insight into the diversity of venture capital investments and, it is hoped, encourage venture capital firms to invest in a wider range of businesses. The F5 Collective, the sponsor of the bill, states:

> SB 54 takes a step towards rectifying this situation by requiring annual reporting of diversity efforts by certain investment entities and individuals. This transparency will hold the investment community accountable and promote more equitable investment practices. The bill's clear definitions and reporting requirements will ensure that accurate and relevant data is collected and made publicly available. We believe that SB 54 will have a positive impact on the venture capital landscape by promoting diversity and inclusion in the sector.

4. Privacy concerns

This bill's provisions for collecting diversity data are modeled after the Insurance Code's Governing Board Diversity Survey, which requires insurers admitted in California with premiums written of over $75,000,000 annually to report to the Insurance Commissioner on its board diversity efforts.[8] A covered insurer is required to submit to its board members, on a biannual basis, a survey seeking the same demographic information sought in this bill from founding team members, and is required to accompany the survey with the same disclosures regarding the right not to participate.[9] The data provided by the surveys is similarly required to be anonymized and presented in the aggregate, and may not be released pursuant to the California Public Records Act.[10]

Here, these privacy-protection measures—accepted by the author in the Senate Banking and Financial Institutions Committee—make the bill significantly less intrusive than the

[8] Ins. Code, § 927.3.
[9] *See id.*, § 927.3(b).
[10] *See id.*, § 927.3(b)(5), (f).

original version of the bill. Nevertheless, the nature of the disclosure requirement raises concerns about individual privacy and possible unintended consequences.

The Governing Board Diversity Survey for insurance companies is an intra-company survey: the company is seeking information from its own governing board members, who presumably have an established relationship with the company and exercise control over the company. Thus, while there is a power differential between the insurance company and the board members receiving the survey, the board members are likely not in a position where they would feel unduly pressured to participate or worry about ramifications for the future.

Here, however, venture capital firms are being tasked with requesting personal demographic data from the founding team members of companies in which they invested. This relationship—investor and start-up seeking venture capital—is significantly less balanced. So while the bill requires survey recipients to be told there will be no adverse results from declining to provide personal information, a founding team member might feel pressure to disclose personal information in order to keep their investors happy. And while the bill prohibits a venture capital firm from seeking the demographic information until after an investment deal has been closed, it is likely that many companies receiving venture capital will be interested in seeking additional funds in the future, at which point their data would already be in the possession of the venture capital firm. At worst, permitting venture capital firms to ask founding team members about personal information could give rise to discrimination, consciously or unconsciously, based on the information provided.

5. Efficacy concerns

The analysis of the Senate Banking and Financial Institutions Committee raises the question of whether this bill's reporting requirement will have the desired effect of shaming venture capital companies into increasing their investment diversity. The analysis describes the venture capital industry as "not only shameless in the investment dollars it seeks, but also willing to make investments in businesses designed to flout, evade, or violate existing laws," and suggests that this bill is unlikely to cause "an industry that apparently engages unabashedly in antisocial behavior respond to public scrutiny about the diversity of their investments." The analysis does suggest that there might be some improvements on the margin, and that the public availability of data could help businesses seeking capital to identify the firms with better track records.

6. Amendments

As noted above, the author has agreed to amendments to clarify certain definitions and clarify that the reports should include information on founding team members who are veterans or disabled veterans. The amendments are set forth below, subject to any nonsubstantive changes Legislative Counsel may make.

<u>Amendment 1</u>

On page 4, in line 9, after the third comma insert “disabled,”

<u>Amendment 2</u>

On page 4, in line 12, strike out “owns initial shares or similar ownership”, strike out lines 13 to 15 inclusive, and insert:

> satisfies 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 of the business.

<u>Amendment 3</u>

On page 4, in line 17, strike out “or”

<u>Amendment 4</u>

On page 4, in line 17, strike out “business” and insert “officer, or manager”

<u>Amendment 5</u>

On page 4, in line 17, strike out “business” and insert:

> business, or who has been designated with a role with a similar level of authority as any of those positions.
> (4) “Primarily founded by diverse founding team members” means a founding team for which more than one-half of the founding team members responded to the survey described in paragraph (2) of subdivision (b) and at least one-half of the founding team members are diverse founding team members.

<u>Amendment 6</u>

On page 4, in line 18, strike out “(4)” and insert “(5)”

<u>Amendment 7</u>

On page 4, in line 21, strike out “(5)” and insert “(6)”

Amendment 8

On page 4, below line 38, insert:

> (vi) Whether any member of the founding team is a veteran or a disabled veteran.

Amendment 9

On page 5, in line 1, strike out "(vi)" and insert "(vii)"

Amendment 10

On page 5, in line 2, strike out "(v)" and insert "(vii)"

Amendment 11

On page 5, in line 4, strike out "total amount funded" and insert "number of venture capital investments"

Amendment 12

On page 5, in line 8, strike out "(v)" and insert "(vi)"

Amendment 13

On page 5, in line 12, strike out "funded" and insert "of venture capital investments"

Amendment 14

On page 5, in line 14, strike out "the total amount of money invested" and insert "venture capital investments made"

Amendment 15

On page 5, in line 16, strike out "(v)" and insert "(vi)"

SUPPORT

F5 Collective (sponsor)
Pyrium
Scroobius Inc.

OPPOSITION

None received

RELATED LEGISLATION

Pending Legislation: AB 1392 (Rodriguez, 2023) requires the Department of Health Care Access and Information to require licensed hospitals with operating expenses of $50,000,000 or more to annually submit a detailed and verifiable plan for increasing procurement from minority, women, LGBT, and disabled veteran business enterprises. AB 1392 is pending before the Assembly Appropriations Committee.

Prior Legislation:

AB 890 (Cervantes, Ch. 472, Stats. 2021) required CalPERS and CalSTRS to each produce and submit an annual report on the participation of emerging managers or diverse managers under contract with each respective fund to manage pension fund assets.

SB 534 (Bradford, Ch. 249, Stats. 2019) reenacted and expanded the insurer Supplier Diversity Survey established in AB 53 (Solorio, Ch. 414, Stats. 2012) codified the requirement that insurers submit a Governing Board Diversity Survey, and established procedures for the California Department of Insurance (CDI) to administer both and publish the results.

AB 3249 (Assembly Committee on Judiciary, Ch. 659, Stats. 2018) among other things, required the State Bar to develop and implement a plan to meet certain goals relating to access, fairness, and diversity in the legal profession and the elimination of bias in the practice of law, and required the State Bar to prepare and submit a report on the plan and its implementation to the Legislature, by March 15, 2019, and biannually thereafter, on the plan and its implementation, as specified.

AB 53 (Solorio, Ch. 414, Stats. 2012) required major insurers to report data to the Insurance Commissioner relating to their contracting with women, minority, and disabled-veteran owned businesses; the provisions sunset on January 1, 2019.

PRIOR VOTES:

Senate Banking and Financial Institutions Committee (Ayes 5, Noes 1)

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