Date of Hearing: June 26, 2023

ASSEMBLY COMMITTEE ON BANKING AND FINANCE
Timothy Grayson, Chair
SB 54 (Skinner) – As Amended May 18, 2023

**SENATE VOTE**: 32-6

**SUBJECT**: Venture capital companies: reporting

**SUMMARY:** Requires a person who acts as an investment adviser to a venture capital company, as specified, to report annually to Civil Rights Department on their funding determinations related to companies primarily founded by diverse founding team members.

Specifically, **this bill**:

1) Defines a "covered person" as a person that:

    a) Acts as an investment adviser to a venture capital company, and

    b) Meets any of the following criteria:

        i) Is a licensed investment adviser under California law,

        ii) Is a registered investment adviser with the federal Securities and Exchange Commission and has filed a required annual notice with the Commissioner of Financial Protection and Innovation.

        iii) Is exempt from registration under a specified federal law related to Venture Capital Fund Advisers and has filed a required report with the Commissioner of Financial Protection and Innovation.

2) 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, veteran or disabled veteran, lesbian, gay, bisexual, transgender, or queer.

3) Defines "founding team member" as:

    a) A person who satisfies all of the following conditions:

        i) The person owns 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 in the business.

    b) A person who has been designated as the chief executive officer, president, chief financial officer, or manager of a business, or who has been designated with a role with a similar level of authority as any of those positions.

4) Requires, commencing on March 1, 2025, and annually thereafter, a covered person to report to the Civil Rights Department (CRD) 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:

      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 is a veteran or a disabled veteran.

      vii) Whether any member of the founding team declined to provide the information in (i)-(vi).

   b) During the prior calendar year, the number and total amount of venture capital investments to businesses primarily founded by diverse founding team members, as a percentage of the total number investments and amount of money invested by the covered person, in the aggregate and broken down into the categories in (i)-(v) of (a) above.

5) Requires a covered person to obtain the information required in #4 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.

6) Requires the survey required by #5 to be a standardized form to be specified by the CRD and requires that the survey must include a “decline to state” option for each question on the survey.

7) Requires a covered person to distribute a written disclosure to each founding team member prior to, or concurrently with, the survey. Provides that the disclosure shall notify the founding team member that their decision to disclose their demographic information is voluntary, that no adverse action may be taken against them if they decline to participate in the survey, and that the aggregate data collected for each demographic category will be reported.

8) Requires a covered person to provide the survey and the disclosure to the founding team members only after the covered person has executed an investment agreement with the business and made the first transfer of funds.

9) Prohibits a covered person or the CRD to in any way encourage, incentivize, or attempt to influence the decision of a founding team member to participate in the survey.

10) Requires a covered person to collect survey response data in a manner that does not associate the data with an individual founding team member and to transmit the data to the CRD in a manner that does not associate the data with any individual founding team member.

11) Requires the CRD to make the reports received from covered persons readily accessible, easily searchable, and easily downloadable on its internet website.

12) Authorizes the CRD to examine the records of a covered person to determine compliance with the requirements outlined above.

13) Requires the CRD to collect an unspecified filing fee from covered persons to recover the expenses of administering their responsibilities under this bill.

14) Requires the CRD to assess a civil penalty of $100,000 to a covered person who fails to submit the required report, as specified.

**EXISTING LAW**:

1) Pursuant to the Corporate Securities Law of 1968, provides for the licensure of investment advisers, who are persons who, for compensation, engage in the business of advising others, either directly or through publications or writings, as to the value of securities or as to the advisability of investing in, purchasing or selling securities, or who, for compensation and as a part of a regular business, publishes analyses or reports concerning securities, unless the person is otherwise exempted or unless the investment adviser is subject to #2 below. (Corporations Code Sections 25009 and 25230)

2) Exempts an investment adviser registered under specified federal law from state licensure, but requires the investment adviser to file an annual notice and pay a fee to the commissioner, as specified, before conducting business in this state. (Corporations Code Section 25230.1)

3) Exempts certain private fund advisers from the licensure requirement described in #1 above, so long as, among other things, the private fund adviser files a report with and pays an annual fee to the commissioner, as specified. (10 CCR Section 260.204.9)

4) Defines "commissioner" as the Commissioner of Financial Protection and Innovation. (Corporations Code Section 25005)

**FISCAL EFFECT**: Unknown. This bill is keyed Fiscal by Legislative Counsel.

**COMMENTS**:

1) Purpose.

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) Venture Capital

Venture capital (VC) is a type of private investment that focuses on early stage businesses with the potential for significant growth. Under a typical VC model, the VC firm will raise money from limited partners to invest in new start-ups or in other, larger VC funds. Funding to start-ups is often provided in exchange for an equity stake in the company.

One of the most notable features of VC funding is the high rate of firm failures and the outsized returns from a small number of successful businesses. Thus, VC firms take different approaches than other lenders when developing their investment strategy, and VC firms often assume investment losses on many of their investments, with the hope that at least some of their investments will pay off in a big way down the line.

Despite the high rate of start-up failures, VC firms are seen as a key driver of economic growth and opportunity. Companies like Apple, Cisco, eBay, Microsoft, and Amazon received venture capital in their early stages, and research suggest that a vibrant venture capital market is one reason why the United States has maintained leadership in technological innovation.[1] According to one 2012 analysis, venture investment made up only

[1] See Annaleena Parhankangas, "The Economic Impact of Venture Capital" (Chicago: University of Illinois at Chicago, 2012) for a detailed review of the literature on VC's economic impact.

0.2% of GDP of the time period analyzed, but had produced approximately 21% of U.S. GDP in the form of VC-backed revenues.[2]

VC is also especially important to California. Traditionally, California has seen an outsized share of VC placement, and these investments have been crucial for the growth of important sectors of the California economy. As the Legislative Analyst's Office notes, VC funding supports high-wage and high-growth sectors in California, and this funding is directly correlated with the state's employment growth. [3]

Unfortunately, despite its overall importance for both entrepreneurs and the economy, VC funding has remained stubbornly unavailable to women and minority founders and entrepreneurs. The lack of diversity in VC funding gives the strong impression that the doors to this crucial financing are open only for a select lucky few based on characteristics over which they have no control. A number of surveys and studies confirm the extent of the problem:

- According to PitchBook, companies with female-only founders comprised 7% of all deals funded in 2022, which represented only 2% of the total capital provided by VCs.[4] Business co-founded by men and women performed marginally better with 20% of all deals funded, representing 16% of the total capital provided.

- A 2016 study by Stanford Institute for Economic Policy and Research found that white entrepreneurs received three times more startup funding than Black counterparts.[5]

- A 2020 analysis by the National Women's Business Council found that women founders received just $2.9 billion, or 2.2%, of the $130 billion in venture capital. [6]

The VC community acknowledges the need to diversify its investments, but this has not led to much change. In 2020, Morgan Stanley conducted a comprehensive survey of VC firms about the VC funding gap, and while 59% of the survey respondents said they could prioritize investments in companies led by women and multicultural entrepreneurs and still maximize returns, yet many of these respondents simply were not doing so.[7]

The Morgan Stanley survey hints at some of the reasons why VC firms are failing to invest in nonwhite or women-run start-ups. First, many of these firms are led by white men, and just 13% of white male venture capitalists reported prioritizing investments in multicultural founders, a lower percentage than those reported by women and nonwhite male VCs. Second, VC firms still rely on traditional and outdated strategies, such as connections within their existing professional networks, to find diverse entrepreneurs. As the Morgan Stanly report

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[2] Annaleena Parhankangas, "The Economic Impact of Venture Capital" (Chicago: University of Illinois at Chicago, 2012).
[3] https://lao.ca.gov/LAOEconTax/Article/Detail/626
[4] https://pitchbook.com/news/articles/the-vc-female-founders-dashboard
[5] https://siepr.stanford.edu/publications/working-paper/black-and-white-access-capital-among-minority-owned-startups
[6] https://www.nwbc.gov/2020/01/15/investing-in-women-owned-businesses/
[7] https://www.morganstanley.com/ideas/venture-capital-funding-gap

notes, more than half of male VCs believe there "aren't enough women founders out there," which suggests some of these firms simply are not looking very hard.[8]

3) What does SB 54 do?

SB 54 requires a "covered person," defined to be an investment advisor to a venture capital firm, to report to CRD specified information related to the gender, race, ethnicity, disability and veteran status, and sexual orientation of the founding members of businesses receiving VC funding. This data, which is aggregated and anonymized, must be collected after the funding agreement has been executed and after the first transfer of funds.

While SB 54 requires an investment advisor to collect this data (and subjects them to fines if they do not), founders are not required to respond. The voluntary nature of the survey is communicated loudly and clearly, and SB 54 requires the VC firm to provide a disclosure to each founding team member stating that the decision to disclose this data is voluntary and that there will be no adverse action against them if they decline to participate.

SB 54 also requires CRD to publish the reports it receives. Therefore, SB 54 includes an element of "public shaming", though it is unclear how these firms will respond to this information being made readily available to the public.

As drafted, there are a number of outstanding questions about the proposed survey. First, it is unclear if the data collection process will lead to response bias or data quality issues. SB 54 intentionally requires the data collected after funding is finalized so that the response does not affect the outcome of the investment deal. However, given that the survey is voluntary, founders are unlikely to feel any urgency to respond, and CRD may not receive complete information.

The above concern is partly a reflection of the bill's unique strategy to deputize VC investment advisors to collect this important information. There may not be a better way to do this, and these issues, if they end up being issues, would not materialize until well after the first year's data is collected and sent to CRD. Committee staff reached out to CRD for technical input, but CRD declined to provide technical assistance.

Another outstanding question, addressed by the committee's proposed amendments, is whether or not the author's office and supporters intend for the data to be specific to the funding of California businesses and start-ups. Currently, SB 54 requires this data for all founder teams, no matter where this team is located. Thus, while SB 54 would provide a useful time series of a VC firm's overall investment strategy, it will not provide many insights into whether these funds are being placed in women-owned or certain minority-owned businesses in California.

4) Budget item

SB 101 (Skinner), which the Legislature passed on June 15, 2023 (but has not been signed by the Governor as of the writing of this analysis), contained $1 million for CRD to implement

[8] https://www.morganstanley.com/ideas/venture-capital-funding-gap

an "equity-in-investment reporting program for venture capital advisors upon enactment of corresponding legislation authorizing the reporting program."

5) Support

F5 Collective is the sponsor of SB 54 and writes:

> Last year, we observed a steep decline in the already meager investment percentage allocated to women. This downturn is so significant that we believe it could adversely affect an en6re future generation of children who will see success represented predominantly by white males. We must address this issue and create an environment where diverse founders have equal access to capital and investment opportuni6es.
>
> SB 54 takes a step towards rectifying this situation by requiring annual repor6ng 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.

6) Amendments

The committee recommends the following amendment to include an indication of whether funding has gone to a team with at least one California resident. This will allow CRD and others to differentiate demographic data for companies with a California nexus, even if some of the founders on the same team live in other states or countries. Given that the primary goal is to explore demographic trends more broadly for each investment advisor, rather than specific trends within California, the committee does not propose anything more robust or complicated.

**Section 22949.85 (b) is amended as follows:**

(b) (1) Commencing on March 1, 2025, and annually thereafter, a covered person shall report to the department 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 in paragraph (2):

(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 is a veteran or a disabled veteran.

**<u>(vii) Whether any member of the founding team is a California resident.</u>**

(vii) Whether any member of the founding team declined to provide any of the information described in clauses (i) to (**<u>vii</u>),** inclusive.

**REGISTERED SUPPORT / OPPOSITION**:

**Support**

F5Collective (sponsor)
Pyrium
Scroobious Inc.

**Opposition**

None on file.

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