IN-DEPTH

Venture Capital Law

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Year in review

For US start-ups, 2023 resembled a reset to the pre-pandemic years of 2018 and 2019. Eleven interest rate hikes by the Federal Reserve, starting in March 2022, led to investor wariness and demands for significantly lower valuations. Despite the resilient US economy and stable unemployment, interest rates reached a 23-year high, eliminating cheap capital. As a result, deal count and capital raised mirrored 2018 and 2019 levels.

Start-ups that raised funds at frothy 2020–2021 valuations avoided raising in 2022–2023 to evade down rounds (i.e., a financing round where the purchase price per share is less than the price in the prior round). However, decreased VC funding led to valuation resets across all start-up stages, raising equity costs while inflation drove up operating expenses. Many start-ups depleted their cash reserves. Facing difficulty raising funds, start-ups suffered down rounds or relied on bridge rounds from existing investors to temporarily extend their runway. In Q4 2023, 19.6 per cent of deals were down rounds, and 45 per cent of Series A financings were bridge rounds, the highest rate on record.

Prominent Silicon Valley venture capitalists predicted a significant increase in start-up failures. Tom Loverro from IVP tweeted about a 'mass extinction event' for early and mid-stage companies in 2023–2024. Data from Carta, a cap table management platform, showed that 87 start-ups that raised at least US$10 million had shut down by October 2023, double the number in 2022, and total start-up shut downs reached 770 in 2023, up from 467 in 2022, the highest since Carta began tracking. Peter Walker, Carta's head of insights, described 2023 as 'the most difficult year for start-ups in at least a decade'.

While the tech sector was in turmoil, a US banking crisis was triggered in March 2023 by the Federal Deposit Insurance Corporation's (FDIC) sudden closure of Silicon Valley Bank (SVB), the 16th-largest US bank by assets. This closure was the second-largest bank failure in US history and the largest since the Great Recession. Two days after the FDIC closed SVB, the regulator closed Signature Bank, resulting in the third-largest bank failure. SVB's collapse was especially hard on start-ups due to its focus on venture-backed companies, founders and venture capitalists. Signature Bank's customer base also included start-ups, founders and risky cryptocurrency customers.

Although concerns about missing payroll and lost deposits eased when the US federal government guaranteed all deposits, the fallout led to a tight debt market and limited borrowing options for start-ups, which are typically considered high-risk debtors.However, large lenders like JPMorgan Chase and HSBC have since entered the venture and start-up lending space. Analysts estimate that over half of SVB's fleeing deposits went to JPMorgan Chase. Under new ownership, SVB has returned to venture lending and retained about 81 per cent of its pre-closure customers. Despite these developments, credit in the venture lending space remains tight over a year after the crisis began.

Increased interest rates and low pandemic-era share prices led many large public tech companies to shift from a growth focus to an emphasis on efficiency and profitability. In Q4 2022, these companies began significant cost-cutting measures, including layoffs. Despite the recovery of tech share prices in 2023 and the anticipation of one or two interest rate cuts in 2024, the focus on profitability and efficiency remains a dominant theme in the public markets and has spread to the private markets. Dwindling cash reserves and limited equity and debt financing options continue to drive start-ups to reduce burn rates, leading to widespread layoffs. In 2023, 1,091 tech companies laid off 263,180 employees, and by 26 July 2024, 376 tech companies had laid off 108,591 employees in 2024.

From a cultural perspective, Covid caused significant shifts in both the location of tech workers and start-ups. During the pandemic, many relocated from high-cost tech hubs, like Silicon Valley, San Francisco and New York, to lower cost tech hubs, such as: Austin, Texas; Nashville, Tennessee; Boulder, Colorado; Boise, Idaho; and other locations. By April 2024, Silicon Valley had lost (and New York City had gained) the largest share of relocating tech talent, while Austin saw the fastest percentage-based growth for top tech talent. For every person who moved from Austin to San Francisco or Seattle, 1.5 people moved to Austin from those cities.

These relocation trends resulted in companies grappling with remote workforce integration from cultural, legal, taxation and technological perspectives. In the first half of 2023, larger tech companies pushed for partial returns to the office, leading to reduced office space and shared desk arrangements. CBRE estimated a 36.8 per cent office vacancy rate in San Francisco for Q2 2024, compared to less than 5 per cent pre-Covid in Q1 2020. Office vacancy rates may begin to decline as AI and other emerging tech companies seek more office space and as companies pursue 'return to office' policies.

Even during the pandemic boom years, start-ups led by female founders did not experience a comparable surge in VC funding. In 2023, US start-ups founded solely by women received only 2.1 per cent of the total capital invested in VC-backed start-ups, while women co-founded start-ups raised 26 per cent. Funding for start-ups with women founders may increase due to the increased formation of women-led venture funds and incubators and grassroots movements supporting women founders. Women-led VC funds are capturing a growing share of venture fund-raising and often invest in start-ups with women founders. Cultural efforts to address the funding gap are also gaining traction. Organisations like the Women's Entrepreneurship Day Organization (WEDO) highlight the gender funding gap and host events to celebrate women entrepreneurs and connect them with investors, such as the San Francisco Bay Area Women's Entrepreneurship Day Gala at the Legion of Honor (co-hosted by Uniting Professional Women Accelerating Relationships & Development (UPWARD)) and the New York Women's Entrepreneurship Day Summit at the United Nations. Additionally, the documentary film 'Show Her the Money' is raising global awareness of the challenges faced by women founders and the support provided by women angel and VC investors.

Another major development has been the continued and intensified regulatory scrutiny of the tech sector, particularly the cryptocurrency industry.Multiple regulatory agencies, including the Securities and Exchange Commission (SEC), have focused on various digital assets and market participants. The SEC's crackdown has impacted fungible tokens, nonfungible tokens or NFTs, stable coins, token issuers, staking operations, crypto lending operations and trading platforms. Recent court decisions show mixed results for the SEC. The agency was compelled to approve the first US-listed spot bitcoin exchange traded funds, or ETFs, following its loss in Grayscale Investments LLC v. SEC.

Furthermore, the Supreme Court's recent overturning of the Chevron Doctrine could complicate future regulatory efforts. Despite some setbacks, the SEC's enforcement actions against Coinbase and Binance are proceeding. Additionally, the Federal Reserve, the FDIC and the Office of the Comptroller of the Currency (OCC) have warned about the liquidity risks of stablecoins, and the Commodity Futures Trading Commission (CFTC) has increased enforcement activities related to cryptocurrency with over 135 actions since 2015.

In response to regulatory intensity, many cryptocurrency companies are seeking friendlier regulatory environments or increasing efforts to influence lawmakers. A group of affiliated super-PACs received US$150 million to elect pro-crypto candidates. Crypto is becoming a mainstream political issue. During the 2024 Nashville Bitcoin Conference, former President Trump promised to end the 'persecution' of the crypto industry, fire SEC Chairman Gary Gensler, establish a bitcoin and cryptocurrency advisory council to create favourable regulatory guidance and make the United States the 'crypto capital of the world'.

Technology companies that monetise user data face additional regulatory hurdles, given regulators' attention on privacy. There is a bipartisan effort at the federal level to pass privacy legislation penalising technology and social media companies for improper use of personal data, particularly children's data. This initiative has led to the proposed American Privacy Rights Act, which includes the Children and Teen's Online Privacy Protection Act, currently before the US House Committee on Energy and Commerce.

States are also increasingly enacting privacy regulations. In 2023, California, Virginia, Colorado, Connecticut and Utah implemented new privacy laws, followed by New Jersey, Kentucky, Nebraska, New Hampshire, Maryland, Minnesota and Rhode Island in 2024. As of 2 July 2024, 20 states had comprehensive data privacy laws, requiring tech companies to update privacy policies and allow customers to opt out of data collection. These changes complicate targeted advertising and email marketing campaigns for tech companies.

The US federal government is also scrutinising content posted on large social media platforms. Congress has formed a special committee to investigate potential federal influence on platform content that may violate free speech. This investigation focuses on whether the current administration and certain regulatory agencies collaborated with social media companies to censor opposing political views. The committee has requested documents from Alphabet, the parent company of YouTube, regarding its policy on censoring content related to firearms and Second Amendment activities. The outcome of this investigation could significantly impact social media companies' content moderation practices, increasing costs and risks while potentially harming their ability to combat disinformation.

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