Cravath Emerging Company and Venture Capital Insights

2024 MID-YEAR MARKET UPDATE

Market Update

VENTURE CAPITAL (VC) ACTIVITY

Global VC funding of companies in the first half of 2024 totaled $126.7 billion—a 6% drop from $135.6 billion in the first half of 2023 and a 2% increase from $123.7 billion in the second half of 2023.[1] Despite the challenging environment surrounding venture capital, the AI space remains an outlier for attracting investment. In Q2 2024, AI startups accounted for 28% of global VC investment, the highest quarterly share to date, drawing $18.3 billion.[2] Driving the trend were deals relating to Elon Musk's xAI along with Corweave and Scale, each completing financings worth over $1 billion.[3]

The continued stagnation in global VC funding seen during the first half of 2024 can be attributed to a variety of factors. Since the immense fundraising and strong market activity of 2021, some VC investors have shifted focus, supporting their most encouraging investments to maturity amidst weak exit opportunities. Macroeconomic headwinds that have plagued the market since 2022 continue to slow deal activity and present uncertainty in 2024. The Federal Reserve has been hesitant to lower interest rates due to concerns over inflation.[4] Additionally, geopolitical tensions and uncertainty regarding a tumultuous U.S. election cycle are contributing to a shaky economic environment for companies and investors. While many financial experts remain optimistic as inflation has largely been curtailed from 2022 levels, the labor market is beginning to cool[5] and macroeconomic uncertainty continues to plague dealmaking and capital availability.[6]

In the U.S., pre-seed and seed companies in particular have struggled to raise funds, with significant declines in deal sizes and valuations. During the first half of 2024, pre-seed/seed rounds experienced their lowest relative share in financing compared to later rounds in 10 years, accounting for less than 30% of deal activity and down from roughly 34% in 2023.[7] Deal value for these rounds during the first half of 2024 fell 20% to $6.5 billion from $8.1 billion during the first half of 2023.[8]

While late-stage deal values in the U.S. during the first half of 2024 are up over 9% to $41.1 billion compared to $37.9 billion during the first half of 2023, over a third of such deal value comes from Coreweave's outsized Series C.[9] Late-stage deal count is down 17%, suggesting that, as a whole, late-stage companies are continuing to encounter financing pressures.[10]

FUNDRAISING

The record fundraising of 2021 and 2022, relatively low level of deal flow and persistent macroeconomic challenges resulted in a surplus of unused capital, which was largely preserved in the first half of 2024. The amount of undeployed capital in the U.S., so-called "dry powder", was estimated to have reached $296.2 billion at the end of the first half of 2024,[11] up slightly from the $279.8 billion in dry powder available at the end of the first half of 2023.[12] As a result, fundraising activity has continued to remain low since 2023, with U.S. VCs raising only $37.4 billion across 255 funds in the first half of 2024.[13] At the current rate, U.S. fundraising is on track to hit the lowest

level since 2019.[14] U.S. fundraising during the first half of 2023 was also low before experiencing a slight rebound in the second half of the year bringing the total to $81.5 billion across 725 funds.[15] Globally VC fundraising for 2024 is on pace to hit its lowest level in 15 years.[16]

Trends in first-time financing VC deal activity are indicative of increasing caution and selectivity among investors. In the first half of 2024, 56 new funds in the U.S. raised $3.7 billion, a sharp decline in pace compared to $14.3 billion that 191 new funds raised throughout 2023.[17] As new funds struggle, larger funds continue to dominate the fundraising scene, raising so far on average $164.2 billion, the highest recorded from PitchBook's data dating back to 2014.[18] This trend is likely a result of a prevailing investor sentiment toward selectivity and risk aversion, and thus, commitment to more established funds. Investor caution has also led to a heightened level of diligence and scrutiny over VC sponsors, which is expected to perpetuate a challenging fundraising environment.[19]

EXIT TRENDS

In the first half of 2024, total U.S. exit value amounted to $49 billion from 634 estimated exit events (*i.e.*, through M&A and public listings), as compared to a total U.S. exit value of $16.4 billion from 591 exit events in the first half of 2023.[20] U.S. IPO markets are showing some signs of strengthening, recording $28.4 billion worth of activity across 37 IPOs in the first half of 2024, reflecting an increase of 492% from $4.8 billion across 35 IPOs in the first half of 2023.[21]

In line with recent trends, mergers and acquisitions have accounted for the bulk of liquidity events, accounting for 92% of exits by count.[22] Notably, however, mergers and acquisitions only accounted for 42% total exit value in the U.S. in the first half of 2024, down from 55% in full year 2023.[23] This change is explained by the concentrated success of four large, highly visible IPOs (Ibotta, Rubrik, Astera Labs and Reddit) that seem to be outliers in relation to recent trends.[24]

Although a historically underutilized tool relative to the private equity market, secondary transactions are providing an avenue for liquidity in a difficult exit market as many venture firms would like to cash out and return capital to LPs. For example, StepStone Group capitalized on this appetite for liquidity and partial exits via secondaries, obtaining a $3.3 billion capital raise for a new secondary venture fund, more than double the amount that was raised in the previous year for all such funds.[25] The secondaries market is expected to continue to play an important role in providing liquidity to investors and employees during the rest of 2024 and beyond.

NON-TRADITIONAL CAPITAL

Although growth companies continue to explore alternative sources of capital, including debt financing (venture debt and other forms), bridge financing and, where applicable to the business, financing on the basis of annualized recurring revenue (ARR), royalty arrangements, licensing and collaboration agreements or other strategic partnerships that involve an infusion of capital, macroeconomic factors and broad investor sentiment have presented barriers to accessing these alternative sources of capital. The high interest rate environment and risk aversion among some investors has also made venture debt less attractive, restricting the additional sources of funding for companies.

The number of down rounds—financing rounds that value the company at a lower value than previous financing—is continuing to climb as interest rates remain high and IPO and M&A activity remain slow. In Q1, the number of flat and down rounds reached a decade high by accounting for over one quarter of VC deals.[26] However, this isn't necessarily as damaging to an emerging company's reputation as it once

was perceived. A poor exit and fundraising environment has given investors leverage to pressure companies who are desperate to secure capital to concede on valuations, and companies and investors have accepted this as a new reality for the time being.

Overall, nontraditional investor participation continues to slow down. In the first half of 2024, total deal count in the U.S. VC market involving non-traditional VC investors (which includes VC groups of private equity funds, corporate venture capital ("CVC"), sovereign wealth funds and asset managers) amounted to 53% of overall U.S. VC deal count, compared to 55% for all of 2023.[27] In a break from recent trends, the value of deals involving crossover investor participation has boomed in the first half of 2024, reaching $43.1 billion, which is 47% and 60% higher than the first and second halves of 2023 respectively.[28] "Crossover" investors are typically asset managers, hedge funds, mutual funds and sovereign wealth funds that have been active in VC investment across any stage.

Special Insights

INDUSTRY SPOTLIGHT—ARTIFICIAL INTELLIGENCE

AI investments continue to lead venture capital funding. The first half of 2024 saw several large AI deals, including a $6 billion investment round in Elon Musk's xAI.[29] There were significant investments in areas beyond the development of foundation models for generative AI, which marked a shift from 2023. Notably, CoreWeave, an AI cloud infrastructure startup, received $1.1 billion in Series C funding, and Xaira Therapeutics, a biotechnology startup using AI for drug discovery and development, raised over $1 billion in committed capital.[30] Scale AI, a data labeling and evaluation startup, also raised $1 billion in late-stage funding.[31] Outside of the U.S., Moonshot AI, a Chinese startup, raised $1 billion in its Series B round.[32] In line with this trend, global AI investments are projected to approach $200 billion by 2025.[33]

While aggressive investing in AI continues globally, a dichotomy has developed in government responses: the EU AI Act entered into force on August 1, 2024, whereas the U.S. currently has no proposed comprehensive federal AI legislation. To fill this gap, nearly every state has introduced state-level legislation aimed at regulating the development or use of AI.[34] The Colorado AI Act (enacted in May 2024 and taking effect in February 2026) will impose disclosure and risk management obligations related to high-risk AI systems and algorithmic discrimination.[35] California's proposed Safe and Secure Innovation for Frontier Artificial Intelligence Models Act (passed by the California Senate in May 2024 and pending California Assembly vote) would also impose broad safety and transparency obligations on large-scale AI systems, if enacted.[36] Several other states have passed narrower laws prohibiting specific generative AI use cases, such as child pornography and deceptive election media. Companies and investors should monitor these legislative developments and assess whether their products and investments fall within the defined categories of AI models and usage subject to these regulations.

Various U.S. federal agencies have also acted on matters concerning the AI industry. AI companies are facing antitrust scrutiny from the Department of Justice ("DOJ") and Federal Trade Commission ("FTC"), which have reportedly initiated investigations into Nvidia, Microsoft and OpenAI.[37] On the other hand, generative AI tools are also increasingly leveraged to respond to Second Requests in the FTC's merger review process.[38] Furthermore, the Securities and Exchange Commission ("SEC") has begun enforcement actions against "AI washing". In May 2024, the SEC announced two settled charges against investment advisors for making false and misleading statements around their use of AI.[39]

In parallel, other agencies are continuing to publish guidance and initiatives tasked by President Biden's 2023 executive order on AI safety and security, including guidance on use of AI in the housing and healthcare sectors, guidelines for critical infrastructure owners and operators, and guidelines for federal contractors, among others.[40]

INDUSTRY SPOTLIGHT—ESG

On March 6, 2024, the SEC adopted long-awaited climate-related disclosure rules for public companies. Although not as prescriptive as the rules that were proposed almost two years prior, the final rules—which will apply to registration statements for IPOs as well as periodic reports—contain broad-sweeping requirements that constitute a significant expansion of the amount of climate-related disclosure required of public companies. As anticipated, litigation challenging the validity of the rules was initiated immediately upon their adoption, and was subsequently consolidated in the Eighth Circuit Court of Appeals. On April 4, 2024, the SEC voluntarily stayed the rules pending the completion of the Eighth Circuit litigation, while noting that it would "continue vigorously defending the [rules'] validity". In a subsequent court filing, the SEC stated that it would provide a new effective date at the conclusion of the stay; it is unclear what impact that may have on the compliance deadlines included in the adopting release. Late-stage private companies that are considering IPOs in the U.S. should monitor this litigation and begin planning to ensure they put in place compliance systems and avoid any unwanted delays should the rules be upheld, including by developing internal controls and procedures for sustainability information and processes to facilitate compliance with the rules' financial statement requirements.

In September and October 2023, California passed the Climate Corporate Data Accountability Act (SB 253) and Greenhouse Gases: Climate-Related Financial Risk (SB 261), which together constitute the most extensive set of mandatory climate disclosure rules in the U.S. These requirements generally apply to companies "doing business in California" that satisfy certain financial thresholds, including private companies. As enacted, SB 253 requires the California Air Resources Board ("CARB") to create new regulations implementing the law by January 1, 2025, with Scope 1 and 2 GHG emissions reporting beginning in 2026 and Scope 3 GHG emissions reporting beginning in 2027 (in each case for the prior fiscal year). On June 8, 2024, California Governor Newsom released proposed amendments to both laws, which, if adopted, will delay compliance deadlines by two years. Specifically, in terms of SB 253, CARB would have until January 1, 2027 to adopt new regulations, with Scope 1 and 2 GHG emissions reporting beginning in 2028 and Scope 3 GHG emissions reporting beginning in 2029. The proposed amendments would similarly delay the compliance deadline for SB 261 (which requires climate risk disclosures) from January 1, 2026 to January 1, 2028.

PRACTICE POINTER—MODEL PIPE FINANCING DOCUMENTS

The National Venture Capital Association ("NVCA") is a trade association that provides model legal documents and forms that are very frequently used in the venture capital industry. The widespread use of NVCA form documentation leads to increased efficiency in progressing VC-related transactions.[41] NVCA recently introduced model PIPE (private investment in public equity) financing documents, including a registration rights agreement, securities purchase agreement, form of pre-funded warrant and form of common warrant.[42] For smaller public companies, in particular, PIPE transactions can be a useful method for securing additional capital quickly without having to go through the burdensome public offering process, especially when market

conditions are disadvantageous. NVCA's model documents are free and seek to "democratize access" to transactional practices and norms in the industry.

Regulatory Developments

AMENDMENTS TO THE DGCL POST-MOELIS

Amendments to Section 122 of the Delaware General Corporation Law of the State of Delaware ("DGCL") took effect on August 1, 2024 to address recent caselaw regarding the facial validity of certain shareholder agreements. In *West Palm Beach Firefighters' Pension Fund v. Moelis & Co.* ("*Moelis*"), the Delaware Chancery Court held that broad consent rights granted to the corporation's founder and controlling shareholder pursuant to a shareholders' agreement, as well as certain rights regarding the composition of the corporation's board of directors and board committees, were facially invalid because they impeded the board's ability to manage the business of the corporation in accordance with Section 141(a) of the DGCL.[43] The amendments effectively overturn the Chancery Court's decision and restore corporate governance practices that were market practice pre-decision. Specifically, the amendments provide that, whether set forth in a certificate of incorporation or not, a corporation has the power to enter into agreements with current or prospective stockholders that contain consent rights and the other provisions addressed in *Moelis*. For example, the amendments allow for covenants that require or restrict future corporate actions specified in the agreement and provisions that require boards to obtain shareholder consent or approval before taking certain actions. Importantly, the proposed amendments do not alter the fiduciary duties of directors, or existing standards of review, with respect to a decision to enter into such agreements. The amendments apply retroactively.

FTC "BANS" NON-COMPETE AGREEMENTS

On April 23, 2024, the FTC voted 3-2 to adopt a final rule (the "Final Rule")[44] broadly deeming non-compete clauses with "workers"—which is defined broadly and includes, among others, employees, executives, officers, directors and independent contractors—to be an "unfair method of competition" under Section 5 of the Federal Trade Commission Act.[45]

As discussed in our April 25, 2024 memo, litigation may ultimately limit or block the Final Rule's application. On July 3, 2024, the United States District Court for the Northern District of Texas granted a preliminary injunction from the Final Rule in *Ryan LLC v. FTC*, which only applies to the *Ryan* parties, pending a final determination of the Final Rule's validity. In contrast with Ryan, the United States District Court for the Eastern District of Pennsylvania in ATS Tree Services, LLC v. FTC denied a similar request for a preliminary injunction on July 23, 2024. A decision by the United States District Court for the Middle District of Florida on a similar motion is expected soon in *Properties of the Villages, Inc. v. FTC*. The Final Rule represents a novel expansion of the FTC's authority. If the Final Rule manages to survive challenge, non-competes could likely still be enforced under state law, but employers could be the target of FTC enforcement actions for doing so.

Many startups and VC-backed companies do not maintain non-competes due, in part, to California's long-standing prohibition of non-competes and the significant portion of venture capital investment that occurs in California-based startups. Startups and VC-backed companies that do not maintain non-competes will be minimally affected by the Final Rule. Startups and VC-backed companies that maintain non-competes should continue to monitor changes to the Final Rule and state rules (*e.g.*, recent changes to the California rules, which, among other things,

require employers to notify employees of the unenforceability of non-competes).

Note that the Final Rule (and California law) permit certain non-competes entered into in connection with a sale of business. Specifically, the Final Rule permits a non-compete to be entered into "by a person pursuant to a bona fide sale of a business entity, of the person's ownership interest in a business entity, or of all or substantially all of a business entity's operating assets".

NEW FINCEN-PROPOSED AML/CFT RULE

Pursuant to the Bank Secrecy Act (the "BSA"), FinCEN proposed a new rule in February 2024 that would require certain investment advisors (including those registered with the SEC under the Investment Advisors Act of 1940, as amended, and those exempt from registration under the venture capital fund advisor or private fund advisor exemptions), to implement and maintain comprehensive risk-based compliance programs with respect to anti-money laundering ("AML") and combatting the financing of terrorism ("CFT").[46] As a complement to the February 2024 proposed rule, the SEC and FinCEN have also jointly proposed a new rule in May 2024 that would require certain investment advisors to maintain comprehensive written customer identification programs.[47] These proposed rules align with U.S. government efforts to bring investment advisors under the broader umbrella of "financial institutions" under the BSA and gather additional data on investors amidst concerns around foreign corruption, fraud, tax evasion and other criminal activities, as well as national security concerns regarding Chinese and Russian investors potentially gaining access to sensitive information and emerging technology.

Currently, the Corporate Transparency Act (the "CTA") broadly exempts pooled investment funds and venture capital advisors from the BSA reporting requirements. The proposed rule would thus add a substantial regulatory burden on VC funds, which would be required to maintain protocols and systems that monitor the transactions of their investors, which would fall within the scope of the BSA requirements. Implementation of comprehensive risk-based AML/CFT compliance would in practice require funds covered under the new rule to know the identities of their investors' beneficial owners. Additional requirements include implementing employee training programs, providing mandatory SARs reports to law enforcement and maintaining recordkeeping procedures that keep track of the transmittal of funds exceeding $3,000.

Implementing comprehensive AML/CFT programs is likely to be quite costly. Fund subscription and operating agreements may need to be adjusted to reflect appropriate cost and risk allocations among parties. Additionally, the new rules could deter investors who do not want to comply with the rules from investing in funds in the first place, placing additional strain on an already-challenged fundraising market.

NVCA has advocated strongly against this rule, claiming that it is "unsuitable and unnecessary" for advisors to VC funds, especially those that "present low risk for facilitating money laundering".[48] Given NVCA's influence in the VC ecosystem, it would not be surprising to find other industry members consider challenging the rule through litigation should it become effective.

1, 2, 3 CB Insights – State of Venture Q2'24 Report, July 3, 2024.

4 Federal Reserve Board – Federal Reserve issues FOMC statement, June 12, 2024.

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6 *VentureBeat* – First look at Q2 2024 venture capital reveals continued struggle for deals, July 2, 2024.

7, 8, 9, 10, 11, 13, 14, 15, 17, 18, 20, 21, 22, 23, 24, 27, 28 PitchBook and National Venture Capital Association (NVCA) – Q2 2024 PitchBook-NVCA Venture Monitor, July 10, 2024.

12 PitchBook and National Venture Capital Association (NVCA) – Q2 2023 PitchBook-NVCA Venture Monitor, July 12, 2023.

16 PitchBook – Global VC fundraising on track for worst year since 2015, July 9, 2024.

19, 41 Chambers and Partner – Venture Capital 2024 - USA | Global Practice Guides, April 22, 2024.

25 *The Wall Street Journal* – Pro Take: StepStone Sees Opportunity in Venture Capital's Liquidity Crunch, June 10, 2024.

26 PitchBook – 2024 US Venture Capital Midyear Update, June 21, 2024.

29 xAI Blog – Series B Funding Round, May 26, 2024.

30 *Crunchbase News* – Megadeals Explode Early In the Year as US Startups Gobble Up More $100M+ Rounds, May 21, 2024.

31 *TechCrunch* – Data-labeling startup Scale AI raises $1B as valuation doubles to $13.8B, May 21, 2024.

32 *TechCrunch* – China's Moonshot AI zooms to $2.5B valuation, raising $1B for an LLM focused on long context, February 21, 2024.

33 Goldman Sachs – AI investment forecast to approach $200 billion globally by 2025, August 1, 2023.

34 *Law360* – Surveying Legislative Trends as States Rush to Regulate AI, April 18, 2024.

35 Colo. Rev. Stat. § 6-1-1701–6-1-1706 (2024); available here.

36 Cal. S.B. 1047 Safe and Secure Innovation for Frontier Artificial Intelligence Models Act (2024); available here.

37 *The New York Times* – U.S. Clears Way for Antitrust Inquiries of Nvidia, Microsoft and OpenAI, June 5, 2024.

38 Lighthouse – Emerging Trends in Second Requests, last visited July 31, 2024.

39 U.S. Securities and Exchange Commission – SEC Charges Two Investment Advisors with Making False and Misleading Statements About Their Use of Artificial Intelligence, March 18, 2024.

40 The White House – Biden-Harris Administration Announces Key AI Actions 180 Days Following President Biden's Landmark Executive Order, April 19, 2024.

42 National Venture Capital Association (NVCA) – Model Legal Documents, last visited July 31, 2024.

43 2024 WL 747180 (Del. Ch. Feb. 23, 2024); available here.

44 The Federal Register – Federal Trade Commission: Non-Compete Clause Rule, 89 Fed. Reg. 38342, May 7, 2024.

45 Refer to our memo dated April 25, 2024 summarizing the Final Rule, the legal challenges it faced at the time and our expectations regarding its future enforcement.

46 The Federal Register – Financial Crimes Enforcement Network: Anti-Money Laundering/Countering the Financing of Terrorism Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers and Exempt Reporting Advisers, 89 Fed. Reg. 12108, February 15, 2024.

47 The Federal Register – Financial Crimes Enforcement Network & Securities and Exchange Commission: Customer Identification Programs for Registered Investment Advisers and Exempt Reporting Advisers, 89 Fed. Reg. 44571, May 21, 2024.

48 Refer to the NVCA's comment to the Notice of Proposed Rulemaking: Anti-Money Laundering/Countering the Financing of Terrorism Program and Suspicious Activity Report Filing Requirements for Registered Investment Advisers and Exempt Reporting Advisers, 89 Fed. Reg. 12108, February 15, 2024.

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