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Venture Capital 2025

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Contributing Editor
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Global Practice Guides

Venture Capital

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2025

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Sullivan & Cromwell LLP provides the highest quality legal advice and representation to clients worldwide. Sullivan & Cromwell's (S&C) record of success and excellent client service have set it apart for more than 140 years and made the firm a model for the modern practice of law. Today, S&C is a leader in each of its core practice areas and in each of its geographic markets. Its more than 900 lawyers conduct a seamless, global practice through a network of 13 offices worldwide. Its capital markets and pre-eminent M&A practices are deeply intertwined with the development of growth companies and their investment structures. As such, S&C regularly represents venture capital investors and growth companies alike, particularly in later-stage and more sizeable transactions.

Contributing Editors

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Global Overview 2025

After the record year of 2021, the global venture capital (VC) industry and the ecosystem encompassing growth companies have been subjected to profound transformations, marked by shifts in key metrics such as elevated discount rates impacting company valuations, a decline in successful exits, and an uptick in investor-friendly deal terms coupled with a surge in bridge financing arrangements. In 2024, most of these challenges persisted as holdovers, with significant elections in a number of major jurisdictions and geopolitical tensions keeping uncertainty at elevated levels throughout much of the year. VC investors continued to be selective with their investments, focusing primarily on more mature ventures and companies with clear paths to profitability. Overall, however, the global VC industry saw a modest year-on-year (YoY) rebound in 2024.

The VC industry and its portfolio companies have evolved to become a shaping force in and for the global economy. Total VC investment volume in 2024 amounted to USD368.3 billion on a worldwide basis, marking a moderate gain from the previous figure of USD345.7 billion (in 2023) and a slight recovery from 2023's five-year low. A total of 35,684 VC-related transactions affecting growth companies globally – including financing rounds, M&A deals, and IPOs – amounted to a further 5.6% decline from the 37,809 transactions recorded in 2023.

Early stage financing continues to dominate in terms of absolute transaction figures, accounting for 69% of all deals. On the other end of the life cycle, total exit value came down even further to USD318.5 billion compared to USD335.1 billion of the preceding year, perpetuating an environment where liquidity events are rare.

Median deal sizes across Series B, C, and D+ rounds rose substantially in both the Americas and Europe compared to 2023, with D+ financings rising the most from USD60 million to USD100 million in the Americas and from USD59.4 million to USD80 million in Europe. Unicorn VC deal flow likewise appreciated significantly to USD119.8 billion in 2024, up from USD84.5 billion in 2023 – with a total of 1,249 active start-up companies now valued at more than USD1 billion globally.

In terms of geographical distribution, the USD204.3 billion deployed in North America again led the way, followed by Asia (USD64.7 billion) and Europe (USD63.8 billion) which saw opposite trendlines in terms of YoY developments (deceleration in Asia; pick up of activity

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in Europe). In terms of micro-geographies, the California Bay Area takes the US's lead, with USD52.1 billion invested in VC-backed companies in 2024. The most prominent and largest California Bay Area deals all went to ventures engaged in AI (Databricks, OpenAI, xAI, Waymo and Anthropic). In Europe, out of the continent's total of USD63.8 billion invested, the UK (USD19.4 billion), France (USD8.8 billion) and Germany (USD8.5 billion) took the top spots. Among the most sizeable European transactions were Wayve (USD1 billion), a venture engaged in the development of a self-learning system for autonomous driving, and British IT infrastructure provider GreenScale (USD1.3 billion).

The most substantial funding round in Asia was secured in Q4 2024 by the Chinese electric vehicle company AVATR, raising USD1.5 billion in a Series C round. Chinese companies also dominated the next largest funding rounds in Asia, with clean energy provider CNNP Rich Energy and electric vehicle joint venture IM Motors at the forefront, each securing USD1.1 billion. Indian e-commerce company Flipkart completes the Asian top fundings with USD1 billion.

Key trends

AI gaining global momentum

In terms of industries, artificial intelligence (AI) globally attracted the most sizeable share of VC investment volume: AI start-ups raised over USD100 billion, accounting for around 29% of all venture funding. The largest deals of 2024 all evolved around renowned AI model and infrastructure players. In the lead, Databricks raised USD10 billion in a Series J round, followed by CoreWeave (USD8.6 billion), OpenAI (USD6.6 billion) and xAI (USD6 billion in two rounds).

Out of the 16 investment rounds exceeding USD1 billion in 2024, nine of those were investments into AI companies, representing 80% of such rounds in terms of value.

Rebound in valuation growth

As the interest rate environment softened further, valuation levels for start-ups cautiously set out on a path towards recovery in 2024 and are expected to rise further in 2025.

Amid challenging geopolitics, macroeconomic uncertainties, and idiosyncratic regional headwinds, the valuations of growth companies have declined since 2021. This trend is reflected both in financing round valuations and the exit value for liquidity events. To illustrate the point, the number of valuation step-ups (increase in a company's pre-money valuation between two consecutive financing rounds) fell to a ten-year low globally in 2023. That said, in the current cycle of the industry downturn, many assess that valuations then had bottomed out.

The global exit value for liquidity events of growth companies (such as M&A trade sales or IPOs) amounted to USD318.5 billion in 2024, a loss compared to the total volume of USD335.1 billion in 2023 and still a long shot from the USD1.5 trillion deployed in 2021. Increased valuations could be observed in both the US (USD149.2 billion in 2024 vs USD120 billion in 2023) and Europe (USD68.1 billion in 2024 vs USD46 billion in 2023), while levels in Asia hit a low point (USD93.2 billion in 2024 vs USD155.8 billion in 2023).

In 2024, around 30% of all financing rounds in the US market saw a flat or reduced pre-money valuation relative to the start-up's last round. In Europe, by contrast, a mild decrease of valuation haircuts (19% in 2023 vs 18.1% in 2024) generally could be regarded as an encouraging sign of a recovery in its early innings which, despite its

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fragility, may accelerate. The median exit value in Europe in 2024 ended 35.1% higher, driven by increased investor appetite for buyout transactions.

Fundraising headwinds

In 2024, fundraising challenges were still evident across the global marketplace. Globally, USD169.7 billion was raised, less than 80% of the USD213.8 billion provided by limited partners (LPs) in the preceding year. In terms of geographical distribution, USD76.1 billion in the US led the way (USD97.5 billion in 2023), followed by USD66 billion provided to Asian VC funds (USD86.7 billion in 2023) and with Europe continuously lagging behind (USD22.5 billion in 2024, virtually flat from 2023 levels).

Besides the reduction in distributions from vintage funds, the further decrease can be attributed to several other factors, including LP withdrawals prompted by a perceived shortage of liquidity events, a reallocation of assets to less volatile classes, attractive public market conditions and a resurgence of crypto, as well as a general hesitation among VCs to inject additional capital into companies facing declining valuation levels.

Fundraising opportunities were increasingly concentrated among sizeable funds with prominent reputations and typically exceeding USD1 billion in targeted fund size, underscoring pre-existing market inclinations towards a concentration of capital allocation. While the total volume of capital raised in the US in 2024 exceeded pre-pandemic levels, fund counts in the US were at decade lows, at merely 31.3% of the number of funds present in 2022 and progressively concentrated among a handful of established firms. Against the backdrop of market fundraising highs in 2021 and 2022, however, total available "dry powder" in the VC industry reached new global record levels standing at USD307.8 billion of deployable capital in 2024.

Shifting the focus towards the Asia-Pacific region, China still finds itself navigating through macroeconomic headwinds against a backdrop of economic challenges. Notably, VC transactions involving Chinese start-ups witnessed a further decline, plummeting from USD63.7 billion in 2023 to USD38 billion in 2024. Sequoia Capital, which has invested in China since 2005, recently initiated the separation of its Chinese operation.

Amid China's economic downturn, international investors seeking opportunities in Asia have directed their attention to other countries. With USD11 billion deployed in 2024, India contributed a significant 27% of the region's venture funding representing a 40% growth trajectory YoY. In Japan, overall VC deal value in 2024 exceeded the total for 2023, primarily driven by significant funding rounds. Moreover, the market more broadly seemed to evolve as US-based Andreessen Horowitz announced plans to open an office in Japan.

Paradigm shift: growth vs profitability

The sustainability of a start-up's business model, its margins, cash flow conversion, adaptable and recurring revenues as well as a clear-cut pathway to profitability have become a (re-)discovered focus area for venture capitalists and the broader community. The intensified pressure recently manifested itself in cost-cutting measures, a significant wave of tech lay-offs and declarations that the "war for talent" is over. At the same time, premiums on growth (as opposed to efficiency) continue to be particularly pronounced in sectors such as next generation software, biotech and AI – indicating a bifurcated market when it

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comes to terms growth companies can demand from investors.

Fewer exits, lackluster distributions

Growth companies continue to face significant challenges with their exit strategies, placing substantial strain on sales processes for businesses. Globally, 2024 saw a total of 8,397 M&A exits (compared to 8,529 in 2023) and 355 IPOs (compared to 444 in 2023). The European market continued to suffer, with 3,472 M&A exits in 2024 (substantially flat from 2023 levels) and 42 IPOs (down from 52 in 2023), while the US likewise felt the impact with 3,055 M&A exits in 2024 vs 3,167 in 2023 and 71 IPOs (up from 65 in 2023). On average, from the time of first funding to IPO, it took VC backed companies that went public in 2024 two years longer than in 2022 – a median of 7.5 years.

In light of the quadrupling of active venture/growth investors during the past decade as well as the massive decline in VC distributions in 2022 and 2023, which has not been seen at this level since the global financial crisis, distributions remained significantly below the ten-year average in 2024 but indicate a slight increase for 2025.

Alternative financing structures

Overall, declining valuations and rocky exit pathways have prompted demand for alternative transaction structures and financing solutions, which have provided a counterpoint to turbulent markets. At the same time, venture debt correlates with overall funding conditions, as equity funding tends to constitute a growth company's primary repayment source.

Non-dilutive measures

With VC backing becoming both scarcer and more costly, start-ups are eyeing non-dilutive financing options as a viable alternative. In 2023, non-dilutive funding for European start-ups increased by 50% compared with the previous year. Unlike venture debt, which may include equity warrants, non-dilutive financing options include revenue-based financing and term loans. While most growth companies continue to prefer external equity financing in order to drive rapid growth, current market conditions have spurred a search for tailored alternative structures.

Bridge rounds

Venture capitalists have increasingly turned to bridge rounds (typically led by, or confined to, existing investors) in order to support their portfolio companies rather than following through with new investment rounds with terms deemed insufficiently attractive. The tendency was particularly discernible among late-stage start-ups, where valuation levels had decreased most significantly. The surge in bridge rounds among early stage start-ups follows an initial period of more favourable capital raising conditions compared to late-stage companies. Bridge rounds were oftentimes combined with a structured element to partially provide liquidity for secondary shares.

Ramifications of trends in deal terms

Deal terms reflect a shifting market

With growth companies running low on cash, a need to raise funds in a compressed timeframe contributed to existing market pressures. Shifting dynamics have led to an altered transactional practice not seen in nearly a decade: venture firms' enhanced negotiation leverage has permitted more investor-friendly terms, including more sizeable equity stakes and increased or cumulative dividend rights (guaranteed returns such as compounding interests as part of the liquidation preference owed to shareholders, irrespective of the company's financial perfor-

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mance). Cumulative dividends were present in 4.7% of all US VC deals with dividends in Q4 2021 and, notably, surged to 23.4% by Q1 2024.

In the realm of anti-dilution provisions, only around 2% of transactions are provided with full anti-dilution ratchets to enhance investor protection during down rounds. Most transactions with anti-dilution protection (approximately 80%) used weighted average ratchets.

In purchase or subscription agreements (other than stock purchase agreements in the US), a tangible tendency for founders to stand behind representations and warranties was discernible. This signals a shift by investors towards risk mitigation and a focus on documented due diligence, reflecting, overall, a more prudent investment approach.

Moreover, the allocation of board observer seats to investors' representatives has increased. This trend mirrors investors' aspirations for increased appetite for engagement in their portfolio companies' governance and business aspects.

Consent rights for the benefit of investors have decreased significantly. Compared to 2023, where in 42% of European convertible financings investors managed to secure consent rights to certain matters, in 2024 only 15% of those convertible financings included consent rights for investors. This marked a shift back to more company-friendly terms, where convertible investors typically do not have consent rights on their convertible investment given their non-equity shareholder status at the time of investment. Despite this, and for reasons similar to the shift in pre-emption rights, convertible investors continued to seek information rights in 49% of convertible financings, marking a 26% increase from 2023.

Liquidation preferences have long been nearly ubiquitous in many jurisdictions, especially in early stage financings. Participating liquidation preferences grant investors the right to receive their originally invested amount in the event of a sale or liquidation and, on top of that, share of any remaining proceeds with holders of common stock on a pro rata basis ("double dip"). A non-participating 1x liquidation preference with a conversion right for the investor typically constitutes the default. Despite shifting economics, there has not been widespread adoption of increasing preference multiples to more than 1x (outside of distress scenarios) while regional practices seem to vary slightly. Any such increases, if agreed upon, are typically tailored to the specific circumstances of the situation. By contrast, investors have more frequently been able to negotiate participating liquidation preferences across all stages of a company's development cycle, compared with recent years.

Continued trend towards standardised documentation

Documentation for equity-based financing continues to move towards standardisation across geographies, with key model documents originating from the US National Venture Capital Association (NVCA), the British Private Equity and Venture Capital Association (BVCA), the German Start-up Association (Bundesverband Deutscher Startups e.V.) and the Simple Agreement for Future Equity (SAFE) (as described in more detail further on in this introductory article). Similar initiatives can be observed in many jurisdictions, including:

- Canada (Canadian Venture Capital and Private Equity Association, or CVCA);
- Singapore (Singapore Venture and Private Capital Association, or SVCA);

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- Switzerland (Swiss Private Equity and Corporate Finance Association, or SECA); and
- China (China Venture Capital and Private Equity Association, or CVCA).

NVCA

The NVCA is a trade association that represents the VC industry in the US. It has been publishing model documents for VC financing rounds since 2003, which have become the industry standard for practitioners and are frequently used even in bespoke and sizeable transactions. The set of documentation is regularly updated once a year to reflect evolving market norms. Today, NVCA documents affect key deal terms and market practice well beyond the shores of the jurisdiction they have been designed for.

BVCA

Similarly, the BVCA provides model documents for early stage investments. They illustrate the value standardised documentation for VC transactions holds across jurisdictions. The BVCA documents are utilised for post-seed early stage investments in the UK, particularly in Series A funding rounds – with the aim of facilitating the adoption of an industry-standard legal framework for such investments.

German Standards Setting Institute

The German Standards Setting Institute (GESSI) is a joint project of Business Angels Germany e.V. and the German Start-up Association, which equips (registered) start-ups, business angels and investors with expertly crafted templates for their essential legal documentation, including convertible loans, term sheets and financing-round agreements.

SAFE

Similarly widespread in adoption – among early stage companies, in particular – is the so-called model SAFE agreement. SAFE governs a financial instrument in the early stage financing context and was originally established in 2013 by renowned incubation hub Y Combinator. The template contemplates equity-like financing in exchange for yet-to-be-issued shares, providing founders with flexibility and control with reduced paperwork. Prior to conversion, the investor's claim is limited to prospectively issuable preference shares – the rights to which are defined in the subsequent financing round. Funds carry no coupon or Paid-in-Kind (PIK) interest in the absence of a predefined maturity.

Key features in SAFE agreements include a valuation cap, which refers to a predetermined maximum for equity upon conversion and discounts investors receive off the price per share paid by new investors in a subsequently priced equity round (with around 20% being the norm). It became the go-to option for US early stage start-ups, owing to its simplicity and focus on future growth potential, and is gradually replacing traditional convertible loan structures as the preferred financing option.

Drawbacks that come with the use of the SAFE structure include an absence of protection or control rights on the part of investors and, with regards to the founding team, a potential underestimation of their collective dilutive effect if used vis-à-vis multiple investors consecutively.

Increasingly exacting foreign direct investment standards

Foreign direct investment regulation has become increasingly relevant in the context of cross-border financing rounds in growth companies, holding the potential to delay closing for non-domestic investors. This trend is evident not only in the US but also in EU countries such as Germany.

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CFIUS

The scope of the Committee on Foreign Investment in the US's (CFIUS) jurisdiction expanded significantly with the enactment of the Foreign Investment Risk Review Modernization Act (FIRRMA) in August 2018. Notably for growth companies, transaction parties are required to submit a mandatory CFIUS filing at least 30 days prior to closing, irrespective of deliberate transaction structuring to grant foreign investors solely passive economic and no other governance or contractual rights. This signifies a re-definition of the "completion date" of a transaction as the date on which any equity transfers to a foreign investor. Most mandatory CFIUS filings relate to US companies involved in advanced technologies (eg, semiconductors) and/or personal data.

On 18 November 2024, the US Department of the Treasury issued a final rule vesting additional authority in CFIUS to review "non-notified" transactions, while generally establishing higher minimum penalties for non-compliance.

Recent developments reflect heightened concern regarding Chinese investors. Prominent examples include the required divestment and removal of improvements on land purchased by MineOne (a Chinese company) within one mile of an Air Force base and the blocking of the Nippon Steel/US Steel transaction after CFIUS referred the deal for a Presidential decision.

For 2025, the US President's "America First Investment Policy" suggests there will be enhanced focus on restricting Chinese investment in "strategic" sectors (including technology, critical infrastructure, healthcare, agriculture, energy, and raw materials), an expansion in the scope of "critical technologies" that can necessitate a mandatory CFIUS filing, the establishment of a "fast-track" review process "to facilitate greater investment from specified allied and partner sources in US businesses involved with US advanced technology and other important areas" and an attempt to work with Congress to expand CFIUS's jurisdiction to review "greenfield" investments.

With effect as of 2 January 2025, a Final Rule issued by the US Department of the Treasury requires US persons to notify certain outbound investment transactions and prohibits certain outbound investment transactions, in each case involving persons of "countries of concern" (currently only China) that engage in "covered activities" involving certain sensitive technologies and products in the semiconductors and microelectronics, quantum information technologies, and AI sectors.

Foreign Trade and Payments Ordinance

The past few years have also seen ever-increasing impediments and more exacting standards of review for non-EU investors. At the EU level, the regulatory framework for foreign direct investment (FDI) control is governed by Regulation (EU) 2019/452. However, a significant variance exists among national screening mechanisms, impacting the effectiveness and efficiency of the system in addressing security and public order concerns. Notably, in Germany, there is a 10% threshold in certain cases of critical infrastructure that may include less sizeable companies. If a non-EU/non-European Free Trade Association foreigner seeks to acquire at least 20% of the voting rights in a German company in one of 19 security-relevant areas of high and future technology, a reporting obligation is triggered.

In 2023, seven EU member states collectively accounted for 85% of all cases submitted, underscoring a concentration of screening activities. Given that 80% of FDIs within the EU were

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concentrated in six key sectors – namely, Information and Communications Technology (ICT), wholesale, retail, financial activities, professional activities and manufacturing – the control of FDI assumed heightened significance in regulating these sectors. The six main jurisdictions of origin were the US, the UK, the United Arab Emirates, China (including Hong Kong), Canada and Japan.

Outlook for 2025

Despite continued significant geopolitical uncertainty, particular headwinds that have held back activity in the VC industry during the post-pandemic years may be fading in 2025: a shift back to more accommodating monetary policy conditions, ventures that have tended to "de-risk" by increasing focus on profitability as opposed to growth, policy trends such as a recognition of the start-up industry as a driver for prosperity in Europe and an openness on the part of the new US administration in respect of crypto-currencies all point to a general resurgence of activity. While the lackluster environment for (sizeable) exits has strained the traditional VC model over the past couple of years, promising candidates, notably in the fintech space, including Stripe, Revolut, Klarna and Chime, may alleviate lingering concerns.

In terms of funds to be deployed, AI is expected to remain the primary focus for VC investors globally. From generative AI that produces content to agentic AI that operates independently, the fields of application are expected to profoundly affect virtually every industry, including healthcare, law and software development. Beyond AI, healthcare and biotech continue to be prime investment sectors, including due to their relative resilience in economic downturns, in both the US and Europe.

Given the current and ongoing geopolitical developments, defence technology and cybersecurity are also becoming increasingly important, illustrated by massive defence technology rounds including, but far from being limited to, California-based Anduril Industries and Mach Industries (specialised in advanced autonomous systems and systems for vertical take-off and landing as well as cruise missiles and other high-performance vehicles) and German start-up Helsing which develops AI software for defence applications. As a notable intergovernmental initiative, the NATO Innovation Fund (NIF) – backed by 24 allied nations and equipped with EUR1 billion – further illustrates the growing institutional focus on defence tech, with prominent venture capitalist Klaus Hommels (Lakestar) serving as chair of NIF's board of directors.

Due to the European Commission's five-year plan to streamline regulations and accelerate investments, an instrumental step in attracting capital for financial services has been taken. The so-called "Omnibus" package covers, inter alia, far-reaching simplifications regarding ESG regulations, and aims to reduce the regulatory burden on businesses and thus enhance the EU's global competitiveness.

Moreover, the movement toward onshoring high-tech manufacturing is in full swing. Developed country jurisdictions globally are striving to reduce their dependence on global supply chains, opening up new and domestic investment opportunities. FDI regulations play a critical role for countries pushing for onshoring by incentivising foreign companies to invest in local production while safeguarding national security, fostering technology transfer, and supporting economic growth.

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Exit opportunities

Broadly, venture capitalists continue to see a limited number of M&A exits, while hoping that IPO activity could increase in 2025. Although a widespread rebound in IPOs may take time, there is cautious optimism – amid significant market concerns – that a re-opening could offer a promising pathway for sizeable exits.

Even if the number of prospective unicorn IPOs in 2025 may be limited, the VC market is expected to feel much-needed relief, because these start-ups hold so much value. According to market observers, 2025 may see IPO activity from companies such as CoreWeave, Stripe (both US), Klarna, Revolut (both Europe), Shein and Contemporary Amperex Technology (both Asia).

For other VC-backed start-ups, the possibility of mid-market or distressed buyouts may be a more feasible and realistic exit option. As many VC-backed companies find growth to constitute a currency in depreciation and start-ups are grappling with a path to profitability, bespoke deal terms and features borrowed from private equity (such as contingent consideration components or purchase price withholding mechanics) may be the sole viable option for many exits to occur. Amongst competitors, share-for-share transactions, often coupled with a cash component, may serve as viable M&A alternative, albeit not perceived by VC backers as an ultimate exit.

As a fading bull-market exit option which is unlikely to be available to growth companies in the near term, special purpose acquisition companies (SPACs) are facing challenges such as disappointing performances, structural issues, and dwindling investor confidence. A substantial portion of the 600-plus SPACs that went public in 2021 are approaching or have already passed their business combination expiration dates, resulting in liquidation without completing a de-SPAC transaction. Since the beginning of 2021, only 467 de-SPAC transactions have been completed.

Evergreen funds

With the obvious challenges created by a lagging market for liquidity events, distributions to LPs and corresponding reinvestments, some have suggested that the at least 200 evergreen funds operating with an indefinite investment horizon in the VC space globally may be part of the industry's response to a shifting investment landscape.

The evergreen fund space is expected by some to grow as the industry tries to mitigate the cyclicality of private markets – albeit subject to regional divergences. The increased flexibility on the part of investment managers may, however, come at the price of significant opportunity costs if and when treasury yields are elevated and assets locked in. The extent to which open-ended investment funds will contribute to addressing temporary market perturbances will therefore be contingent upon the evolution of LPs' investment preferences, risk appetite, and patience.

Expansion of the secondary market

Private secondary transactions have emerged as a crucial component of the market, enabling private companies' shareholders to sell in the absence of a liquidity event in order to generate liquidity for other investment opportunities or personal financial needs. The structuring of such transactions has become more sophisticated as it involves the handling of contractual restrictions such as rights of first refusal and, more recently, involved tender offers to later-round investors. Existing secondary investment platforms can

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open doors to diversification across different industries, stages of growth and geographies.

In recent years, numerous successful growth companies found themselves compelled to remain private for extended periods. This contrasts with the dynamics that prevailed throughout most of the 2010s, when the choice may have been strategic and driven by abundant private funding options. However, given diminishing exit opportunities at sufficiently attractive terms, this decision has become less discretionary in today's market conditions. Especially for early stage investors, secondary markets can offer an attractive opportunity to exit their investment earlier than anticipated, which becomes particularly pressing when the start-up experiences substantial value appreciation prior to reaching a stage where it either goes public or becomes an attractive M&A target.

At the same time, substantial challenges remain, especially concerning information disparity and particularly on the buy side, where investor demand and willingness to conduct due diligence on growth companies may not be able to adequately address existing supply at all times. Buyers have been seen to anticipate steep discounts regarding the net present value of their investment objects. Nonetheless, liquidity in the private marketplace has increased during the past few years, facilitated by initiatives such as Nasdaq Private Market, an initiative by the London Stock Exchange that has facilitated more than USD45 billion in transactional volume since inception; Forge Global, that expanded into the European market in 2024; and others.

The global marketplace for secondary transactions grew from USD109 billion to a record high of USD152 billion. Against this background, some expect that discounts may become less pronounced in the future or even cross into premiums, leading to secondary purchases above market value. This trend may exacerbate investor hype for access to particular companies (such as those in AI) and widen the chasm between the top performers and lower-conviction start-ups.

Complementary financing structures

With VC deal-making expected by many to rebound in 2025, there is potential for a shift towards a more coherent blend of equity and non-dilutive financing within the capital structure of growth companies.

Globally, start-ups are facing an environment still shaped by a non-negligible discount rate, making debt funding an option that requires careful consideration. However, as existing loans mature, borrowers will likely seek refinancing options and placing reliance solely on equity financing may not suffice. Additionally, there is likely to be a growing demand for non-dilutive debt financing in sectors requiring substantial capital investment – for example, real estate, crypto-mining, aerospace and space technology, as well as clean energy and renewable technology. Besides a persistent bid-ask spread between investors and start-ups as to the valuation evolution of sophisticated private credit concepts, as well as certain subsidised programmes (such as that operated by the European Investment Bank) have contributed to the increasing popularity of venture debt which studies assess accounts for as much as 15% of all venture capital transactions in the US. Worldwide, venture debt is forecast to reach a market volume of USD43.16 billion in 2025.

Anticipated rebound in VC deal-making in 2025

Notwithstanding persistent challenges in the VC market and the struggles faced by many companies in securing funding since 2021, VC deal-

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making is anticipated to rebound to a certain extent in 2025 and beyond.

Investors are hopeful that macroeconomic and monetary policy conditions will provide for a sufficient degree of certainty, permitting a deployment of dry powder and an exploitation of backlogged opportunities due to a lack of activity since 2023. On the other hand, pressures to find exit opportunities exist, as LPs are yet to realise capital inflows often perceived as overdue and the number of exit candidates with significant valuations has been growing.

VC investments in AI, in particular, can be expected to further outpace investment in all other sectors – even though the focus may broaden into a wider range of sub-sectors including industry solutions and AI-enabled robotics. While the development of crypto, fintech or cleantech are highly contingent upon broader macro trends, industries such as defence tech and cybersecurity will likely continue to attract interest from VC investors against the background of geopolitical tensions.

Market observers believe that there will not be a return to the heady days of 2021, as start-ups and investors act with more discipline going forward. Nonetheless, growth companies and the VC industry will most likely be key drivers behind many of the breakthroughs and innovations of the 21st century and a shaping force for the long-term fate of the global economy.

ARGENTINA

Law and Practice

Contributed by:
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TCA Tanoira Cassagne is one of Argentina's leading full-service law firms, founded in 2011 and based in Buenos Aires. The firm advises clients across a broad spectrum of industries, with a particular focus on start-ups, venture capital, M&A and capital markets. The firm's venture capital team, the largest in Latin America, consists of over 20 professionals, offering comprehensive legal services in structuring investments, fundraising, cross-border transactions and corporate governance. Based in Buenos Aires, TCA also provides legal counsel to tech start-ups, corporations and venture capital funds in the region. Among the firm's clients in the venture capital space are Galicia, Mural, Rappi, Xapo, Cabify, Bresh, Newtopia, The Yield Lab, Byx Ventures, YPF Ventures, Newtopia, Shefa VC (IRSA), NATAN VC (Bind), Blukap Ventures, Alina VC, Innventure, Panambi Ventures, which receive assistance with a variety of complex transactions and regulatory matters.

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1. Trends

1.1 VC Market

Market Overview

Argentina has one of Latin America's longest-standing start-up ecosystems, with roots stretching back to 1999. Despite facing economic ups and downs and a shortage of available capital, this ecosystem has shown remarkable staying power and promise for growth. If Argentina stabilises its economy, opens up to international markets, and reduces its tax burden, it could become a major venture capital hub in the region. The country has a large pool of skilled professionals and innovative talent that it could leverage for growth.

1.2 Key Trends

Current Trends in Venture Capital Investments

Over the past year, global economic pressures have reshaped venture capital activity in Argentina. Investors have faced a tough landscape with reduced liquidity, prompting more cautious deal-making and a wave of down rounds leading to fewer deals and lower valuations. This shift has pushed due diligence into sharper focus, with start-ups now judged more on solid revenue and traction rather than projections.

Financing has leaned heavily on SAFE (Simple Agreement for Future Equity) rounds, while traditional equity deals have been less common. Valuations, once inflated by a flood of US capital post-pandemic, have adjusted downward as American monetary policy tightened, hitting Latin America, one of the world's least-funded regions, particularly hard. Many Argentine start-ups struggled to secure funding, resulting in staff cuts and valuation declines.

However, 2024 brought a modest upturn, especially in biotechnology, driven by venture funds and accelerators like SF500 and GridX. Foodtech and agritech companies also experienced growth.

Political changes have added another layer to these trends. Fundraising slowed before the 2024 US elections, but Argentina's new government policies after the elections drew investor interest to the region. The country is gaining attention as a prime spot for investments in lithium, oil and gas, mining, and knowledge-driven sectors, with deal activity picking up sharply by early 2025 compared to late 2024, and increasing significantly in early 2025.

1.3 Key Industries

Leading Industries in Venture Capital

In 2024, foodtech and agtech topped Argentina's venture capital scene, fuelled by a push for sustainable practices and origin-based food certification. Biotech also stood out, boosting efficiency and cutting chemical use in agriculture, a vital sector for Argentina and Brazil, both global food production leaders. The region's early embrace of tech solutions, driven by climate pressures and tight agricultural timelines, has made it a hotspot for testing new ideas.

Market insights highlight the key sectors attracting funds in 2024: agtech; entertainment; foodtech; biotech; SaaS (software as a service); and AI.

Notable transactions from last year include:

- BRESH in entertainment;
- AgroToken in agtech with a SAFE round of USD12.5 million;
- Nera in agtech, with a capital injection of USD10 million;
- Kilimo in agtech with a Series A round of USD7.5 million;

- Debmedia/Numia in SaaS with a Series A round of USD3.5 million;
- Biomakers in biotech with a Series A round of USD3.5 million;
- DeepAgro in agtech with a SAFE round of USD2 million;
- Calice in biotech/AI with a SAFE round of USD2 million; and
- Teramot in AI with a SAFE round of USD1 million.

Investment in 2024 focused on growth and scaling rather than exits, with few significant liquidity events recorded. The emphasis remained on building stronger foundations for future expansion.

2. Venture Capital Funds

2.1 Fund Structure

Venture Capital Fund Structures in Argentina

How funds are organised and structured

Argentina's VC funds align with global standards, adapting their structures to maximise efficiency while complying with local and international regulations.

Venture capital funds in Argentina adapt their set-ups based on who is investing and the local rules they must follow. Two main approaches dominate. First, local trusts, known as *fideicomisos*, are popular for funds chasing tax advantages through the *Incentivo al Capital Emprendedor* (ICE) programme. These funds must register with the *Registro de Instituciones de Capital Emprendedor* (RICE), submitting details of their value proposition and ecosystem experience to the *Registro Público de Comercio* (Public Registry of Commerce) and tax authorities (AFIP/ARCA). Here, the general partner acts as the trustee, limited partners provide the capital, and a management team, supported by an investment committee, guides the strategy.

Second, many funds opt for international structures to ease cross-border investments, often setting up in jurisdictions like the Cayman Islands (22.12% of all estimated fund domicile registrations), Ireland (20.41%), Delaware (19.61%), Luxembourg (18.57%), British Virgin Islands (2.07%) or Canada (1.94%). Jurisdictions like Cayman Islands and British Virgin Islands typically follow a limited partnership model, governed by limited partnership agreements or trust agreements. Some funds blend both approaches, pairing an Argentine trust for local investors with an offshore entity for regional plays, sometimes adding special purpose vehicles (SPVs) for tax or strategy benefits. Whether a fund opts for a regulated or unregulated path depends on investor needs and legal demands.

2.2 Fund Economics

Market Standard Terms for Fund Principals

As stated in **2.1 Fund Structure**, Argentina's VC funds align with global standards. Fund managers and key players in venture capital funds share in the financial upside through several channels. Management fees, usually around 2% of committed capital each year, provide steady income. Carried interest, often set at 20% of profits once investors recover their initial stakes, rewards strong performance. Principals might also co-invest their own money to align their goals with investors, while performance bonuses kick in for exceeding targets, and equity in the general partner entity, tied to vesting schedules, secures long-term commitment.

To protect investors and ensure good governance, funds include:

- preferred returns, often 8%, ensuring investors see gains before carried interest is paid;
- investment committees to vet deals and stick to the fund's plan;
- veto rights for limited partners on big decisions like strategy shifts;
- rules requiring approval for changes in fund direction; and
- vesting timelines for carried interest and general partner shares.

These mechanisms balance risk and reward, keeping managers and investors on the same page.

2.3 Fund Regulation

Regulatory Landscape for Venture Capital Funds in Argentina

In Argentina, there is no specific regulation directly governing venture capital funds. However, a regulatory framework exists primarily for the *Incentivo al Capital Emprendedor* (ICE) programme, which provides a specific tax benefit for eligible funds. This framework, though, is not considered a regulation per se but rather a set of guidelines aimed at promoting entrepreneurship.

Venture capital funds in Argentina may operate under general commercial law, primarily governed by the *Código Civil y Comercial* (Civil and Commercial Code), and in some cases, by the *Ley de Apoyo al Capital Emprendedor* (Law of Support for Entrepreneurial Capital). The ICE programme's legal provisions are mainly relevant when seeking tax benefits and require the fund to comply with a set of specific conditions.

Furthermore, the funds must operate as a *fideicomiso* (trust). They are subject to general commercial law and require the appointment of a trustee and the establishment of a governance structure.

2.4 Particularities

Venture Capital Funds in Argentina

Argentina's venture capital scene features a mix of private and corporate players, though government-backed efforts have decreased. Private funds like Newtopia, backed by family offices, athletes and entrepreneurs, focus on local start-ups, while The Yield Lab Latam, Xperiment, Innventure and Pampa Start target agtech. Other VC funds such as SHEFA Ventures, Alina VC, Cometa and BYX Ventures also play a fundamental role in the LATAM VC ecosystem.

Government support has shrunk, with initiatives like the *Fondo Semilla* (Seed Fund) and FONDCE (National Entrepreneur Capital Fund) fading under recent administrations. Some provinces, such as Córdoba, keep co-investment alive on a smaller scale. Meanwhile, corporate venture capital is on the rise, driven by tax incentives and firms like Nestlé and Bimbo reinvesting profits into innovation.

ESG principles now shape most funds in Argentina, blending impact with profit motives.

Also, with exits scarce, funds are stretching holding periods, sometimes to ten years, using secondary vehicles or helping start-ups land clients to boost short-term revenue.

3. Investments in Venture Capital Portfolio Companies

3.1 Due Diligence

Due Diligence and Financing Rounds

Key areas of focus in due diligence

When evaluating start-ups, venture capital investors in Argentina dig deep into legal, financial and operational details. They examine the cap table to confirm ownership aligns with the founding team and past investors. The company's legal structure gets a detailed check for compliance with local rules, while founders' vesting agreements are reviewed to ensure they're locked in for the long term. Contracts with employees and contractors are examined for labour law adherence, and the equity incentive plan is evaluated to see if it motivates staff effectively.

Past financing rounds and agreements reveal the start-up's capital history, while major commercial deals and partnerships clarify on operational strengths and risks. Non-compete clauses and information access agreements post-investment also are examined to limit potential pitfalls.

3.2 Process

Timing and Dynamics of Financing Rounds

A new financing round for a growth company in Argentina typically spans from three to six months for SAFE deals, although delays can stretch this timeline. Equity rounds, requiring greater efforts to secure funding, often take six to nine months to close, depending on the deal's scale and the parties involved.

Existing investors with convertible securities, new investors, founders and employees all play roles, with the lead investor, often in the Series A round, setting terms that others follow.

Separate legal counsel for the lead investor and the company maintains the separation of interests while the company's lawyer typically handles SAFE holders and institutional investors, aligning founders and staff under one umbrella.

3.3 Investment Structure

Types of Instruments in Early-Stage Financings

The majority of start-ups in Argentina use standard industry templates from YCombinator (YC) and National Venture Capital Association (NVCA). The YC template for SAFE agreements is commonly used, particularly in the early stages of investment, and adapted to the local context. Additionally, the NVCA templates for equity financing are also used, with necessary adaptations to reflect the realities of Latin American markets.

Various instruments other than common stock are frequently used in early-stage financings. These instruments often include SAFE and warrants, depending on the circumstances and the specific needs of the company.

SAFE is one of the most common instruments used in early-stage financings. It provides investors with the right to convert their investment into equity at a later financing round, typically with a discount, a target date and certain liquidation preferences.

- Discount: Investors typically receive a discount on the next financing round.
- Target date: The SAFE may have a target date, upon which it will convert to equity if certain conditions are met. This feature is often used due to the lack of liquidity in the industry, and to be able to resolve and give the investor the option to incorporate themselves into the company's cap table and

participate in the company's future decisions. This is at the investor's discretion.
- Liquidation preference: In the event of liquidation, SAFE holders may have a defined priority for repayment.

Investors also typically sign a side letter to the SAFE that acknowledges additional rights that will govern from the moment of their investment or from the moment they convert the SAFE, depending on the type of right.

- ROFR (right of first refusal): Investors may have the right to purchase shares before they are offered to third parties.
- Information rights: Investors often request regular updates on the company's financials and operations.
- Anti-dilution: Protects investors from dilution in future rounds, often through weighted average or full ratchet mechanisms.
- Drag-along: In certain cases, minority shareholders may be required to sell their shares if the majority shareholder decides to sell the company.
- Director appointments: Investors in later rounds (such as Series A) often have the right to appoint a director to the company's board.

While less common, warrants may occasionally be used in Argentina. This instrument gives the holder the right to purchase shares of the company at a predetermined price in the future, offering flexibility for both investors and companies.

Given the regulatory landscape in Argentina, particularly with currency restrictions, investors may find the need to engage in creative legal structures to ensure efficient investment flows into local companies. For instance, the investment framework agreement and irrevocable capital contribution agreements are used to adapt the funding structure in light of local legal and economic conditions.

3.4 Documentation

Core Documents in Financing Rounds

One of the defining features of Argentina's venture capital ecosystem is the lack of local investment rounds. The main reasons for this include legal uncertainty, excessive bureaucracy and complex regulations, and lengthy administrative processes, which are incompatible with the fast-paced nature of start-ups and lack of tax incentives.

Due to these factors, most Argentine start-ups seeking seed or pre-seed funding do so through a holding company in the US, United Kingdom, British Virgin Islands or Cayman Islands, which provides legal security and eliminates restrictions for foreign investors. While a foreign investor entering as a shareholder in Argentina faces regulatory barriers, VC-approved structures facilitate capital inflows and outflows, helping start-ups secure funding more efficiently.

Key documents in Argentine financing rounds are typically global and standard in the VC market. These documents vary depending on the type of round, such as a SAFE or an equity round. The core key documents that comprise a financing round in a growth company include the following.

- SAFE: The SAFE agreement, often based on the YCombinator (YC) template, is a popular instrument in early-stage financing rounds. It grants the investor the right to convert their investment into equity at a later round. In Argentina, the SAFE is commonly adapted with a discount and a target date to suit the local regulatory context and provide certainty

to investors. Some companies may also use pre-money or post-money SAFE structures, with the latter being more common.

- Term sheet: The term sheet outlines the primary terms and conditions of the financing, including the investment amount, the type of securities issued (such as preferred or common stock), and key investor rights such as liquidation preferences or voting rights.
- Shareholders' agreement: This agreement governs the relationship between the company's shareholders and contains provisions like anti-dilution rights, tag-along rights, drag-along rights and exit clauses. It also specifies the governance structure of the company.
- Investment agreement: This formal agreement details the terms of the investment, confirming the investor's commitment and the number of shares or securities to be issued, as well as any conditions precedent to the investment.
- Subscription agreement: The subscription agreement is used when an investor subscribes for shares in the company. It formalises the investment commitment and is typically executed alongside the investment agreement.
- Investment framework agreement: In some cases, an *Acuerdo Marco de Inversión* (Investment Framework Agreement) is used, especially when a holding company is involved, or when irrevocable capital contributions are required. This agreement sets out the general terms and conditions of the investment, and may also involve a swap mechanism or the issuance of preferred shares in the local operating company.

3.5 Investor Safeguards

Safeguards in Downside Scenarios

The market has shifted significantly since the boom years of 2020–2021, when many start-ups raised large amounts of capital in a liquidity-driven market. However, after the *"bubble"* burst, valuations have deflated, leading to more cautious investment strategies. In this new environment, investors focus heavily on provisions that protect their positions in scenarios where future funding may be at lower valuations. The inclusion of anti-dilution clauses, MFN and pro-rata rights has become more prevalent as investors seek to protect their capital.

The down rounds have become more common due to these market shifts, and the increased caution and valuation adjustments reflect the industry's response to this new reality.

The inclusion of a target date in investment agreements is another key tool used by investors, particularly due to the lack of liquidity in the industry. A target date allows the investor to eventually convert their investment, ensuring they have the option to participate in future decisions of the company. This is typically at the discretion of the investor and gives them the flexibility to incorporate themselves into the company's decision-making process.

Strategic investors, particularly Corporate Venture Capital (CVC) funds, may also include observer rights in their agreements, allowing them to attend board meetings without having a formal seat. These investors often avoid appointing directors to retain a less intrusive role, but they seek to be involved in the company's strategy and development. Such rights are commonly included in side letters, rather than in the main investment documents, to ensure they do not complicate the primary investment agreement.

In tough times, investors secure protections. Discounts tied to valuation caps ensure cheap-

er shares in future rounds. Anti-dilution clauses guard against value drops in down rounds, while pro rata rights let investors maintain their stake. *"Most favoured nation"* clauses lock in the best future terms, and put/call options offer exit flexibility. Target dates in agreements provide conversion options, which given the current landscape of restricted liquidity, it is especially critical.

As the market has evolved, these terms have become more prevalent and essential in the negotiation process.

3.6 Corporate Governance

Investor Influence on Management and Governance

Investors gain more control as the start-up matures. In early-stage ventures, the influence that investors have over management and the company's affairs varies depending on the type of investor involved. However, there are some standard rights that typically apply, especially as the company matures and goes through rounds like Series A.

Before a company reaches a Series A financing round, investors may secure *"observer rights"*. This gives them the ability to attend board meetings and observe the company's operations without having a formal vote or decision-making power. This is especially common for early-stage investors, like angel investors or smaller venture funds, which want to keep track of the company's progress.

Once the company raises a Series A round, the lead investor typically negotiates for the right to appoint a director to the board of the company. This provides the investor with more direct influence over the company's decisions, strategies and operations. The lead investor's involvement can significantly impact governance, and often, their appointed director has a key say in major decisions.

Additionally, the inclusion of *"protective provisions"* in the investment agreement grants investors veto power or special rights pertaining to specific actions the company may take, including raising additional financing, selling the company, or implementing significant operational changes. Protective provisions are designed to safeguard the investors' interests, ensuring they have a say in critical matters even if they do not have a controlling stake.

The influence of CVC investors is typically more pronounced due to their dual role as investors and strategic partners. CVCs often aim to create synergies with the start-up beyond mere financial investment, and they may engage in commercial agreements or strategic alliances that go beyond the typical investment contract. These strategic collaborations might include opening new business lines or providing operational support, thus becoming more deeply involved in the company's operations.

Overall, the level of influence an investor has is directly correlated with their investment's size, their role in the financing round (eg, lead investor) and the strategic value they bring to the table. The company's founders also play a role in defining the relationship, as they may request specific support from investors in areas beyond just capital.

3.7 Contractual Protection

Representations, Warranties, Covenants and Recourse in a Financing Round

Financing deals include assurances from both sides. Companies confirm their structure, IP ownership, employee status and lack of legal

disputes. Covenants limit structural or business shifts without approval. Breaches trigger arbitration, preferred for speed, especially under foreign law, or commercial court action, ensuring recourse aligns with the deal's scope.

Representations and warranties typically include aspects such as:

- corporate structure – confirmation regarding the existence of subsidiaries, cap table distribution and the legal standing of the company;
- intellectual property (IP) – ensuring that intellectual property rights are properly registered and that there are no infringements;
- employees – confirmation regarding employment contracts, benefits and any ongoing disputes related to employees;
- litigation – verifying that there are no ongoing lawsuits or potential legal threats that could affect the company's viability; and
- covenants – which include obligations of the company throughout the duration of the investment, such as: no changes to the corporate structure without investor approval; and protection against significant changes in the business, such as alterations in the business model or the sale of key assets.

Regarding financing rounds, SAFE agreements tend to have a lighter scope in terms of representations and warranties compared to equity rounds, where more detailed obligations and commitments are included. However, both types of instruments share a similar structure regarding the parties' obligations.

In the event of a breach of these representations, warranties or covenants, remedy mechanisms or compensation provisions are typically set out, which generally involve:

- arbitration – in many cases, arbitration is preferred over ordinary courts, especially when the contracts are governed by foreign law. This mechanism allows for quicker and more efficient dispute resolution; and
- legal action – if arbitration is not viable or preferred, commercial courts may be used, either locally or internationally, depending on the circumstances.

4. Government Inducements

4.1 Subsidy Programmes

Government Initiatives and Tax Considerations

Programmes supporting growth company financing

Argentina's government offers slim support for equity financing. The *Ley de Apoyo al Capital Emprendedor* (Law of Support for Entrepreneurial Capital) once backed the *Fondo Nacional de Capital Emprendedor* (FONDCE), but recent cuts have axed this fund, leaving only the *Incentivo al Capital Emprendedor* (ICE) tax incentive for corporate income tax relief. Provinces like Buenos Aires City, Córdoba and Santa Fe provide smaller-scale tax breaks and incubator support, though these lean more toward guidance than cash. Private accelerators and angel investors often step in where public funding falls short.

Argentina has limited government support for equity financings in growth companies. However, there are a few programmes and initiatives aimed at fostering entrepreneurial capital and supporting early-stage companies.

- *Ley de Apoyo al Capital Emprendedor* (Law of Support for Entrepreneurial Capital): The 27.349 Law established the *Fondo Nacional de Capital Emprendedor* (FONDCE), aimed

at promoting venture capital investments in early-stage companies. Although the law remains in effect, the current government has eliminated the fund, significantly reducing liquid capital support from the national government. The only remaining form of support is the tax incentive through the ICE, which provides fiscal benefits related to corporate income taxes.

- Local government programmes: Certain provinces like the Ciudad de Buenos Aires, Mendoza, Córdoba, Santa Fe and Entre Ríos, offer localised initiatives. However, these initiatives are relatively limited and are often more focused on support services rather than direct funding.
- Alternative government-backed programmes: While direct funding from the government has diminished, initiatives from private accelerators, incubators and angel investors often fill the gap in early-stage company support. These programmes are crucial for start-ups seeking mentorship and business development opportunities in the absence of substantial public financing.

In the current economic context, with the country facing significant macroeconomic challenges, government funding for start-ups is scarce. The lack of venture capital funds, coupled with the absence of a developed capital market or traditional financing tools (such as bank loans for start-ups or pension funds for VC investments), has led to Argentina's entrepreneurial ecosystem competing on a regional scale with fewer resources compared to other countries. However, despite these challenges, Argentina continues to have one of the most dynamic entrepreneurial ecosystems in the world.

4.2 Tax Treatment

Tax Implications

Tax benefits for start-up investors are limited. The *Ley de Apoyo al Capital Emprendedor* (Law of Support for Entrepreneurial Capital) offers limited relief; while the deductibility of individual equity investments exists, the Argentine tax system presents less favourable conditions for investors compared to other jurisdictions.

The *Ley de Economía del Conocimiento* (Law of Knowledge Economy) aids tech start-ups with income tax exemptions and credits, but these mostly benefit companies, not investors directly.

With *Fondo Nacional de Capital Emprendedor* (FONDCE) gone, government support depends on I *ncentivo al Capital Emprendedor* (ICE) and provincial efforts. The lack of available financial tools is holding back Argentina's ecosystem, forcing it to rely on private capital.

The tax treatment of investments in growth, start-up and venture capital fund portfolio companies in Argentina has some key characteristics, with a focus on tax incentives and capital gains taxation. While there are limited benefits, some initiatives aim to stimulate investment in the entrepreneurial ecosystem, the details of which are as follows.

Individual investors may make personal investments in start-ups and potentially deduct these investments. This tax relief is available for individuals making direct equity investments, but the process remains relatively underdeveloped in comparison to other jurisdictions.

While there were plans to provide significant financial backing to entrepreneurs and growth companies, the elimination of FONDCE and mac-

roeconomic challenges have led to a decrease in government-driven investment initiatives.

As a result, Argentina competes with other regional markets that have more developed financing tools, even though it maintains one of the most dynamic and innovative start-up ecosystems globally.

4.3 Government Endorsement

Efforts to Boost Equity Financing

Apart from the programmes already mentioned in this chapter, there are very few government or quasi-government initiatives in Argentina specifically designed to incentivise equity financing for growth companies. Most existing programmes provide limited fiscal benefits or non-financial support, without deploying significant capital.

However, the private sector and international VC funds are increasingly stepping in, recognising the potential and strong entrepreneurial talent emerging from Argentina's ecosystem.

5. Employment Incentives

5.1 General

Founders and Key Employees

Ensuring long-term dedication

Keeping founders and key staff committed is vital in Argentina's start-ups. Vesting agreements, typically for a period of four years with a one-year cliff, tie, founders' equity to their time and dedication with the company. Equity incentives like stock options or restricted stock units, motivate employees. Earn-outs in exits, performance bonuses, non-compete clauses and a shared company vision further build loyalty, mixing financial incentives with cultural connections.

Securing the long-term commitment of founders and key employees is crucial for the success of growth companies and start-ups. Several mechanisms are commonly employed to ensure that founders and key employees remain dedicated to the venture.

- Founder vesting agreement: A vesting agreement is the most widely used tool to ensure that founders stay committed over time. Typically, a four-year vesting schedule with a one-year cliff is implemented. This means the founder's equity is earned gradually over a four-year period, and if they leave before the one-year mark, they forfeit any unvested equity. The vesting agreement is structured to prevent founders from leaving early and taking equity with them while encouraging them to contribute to the company's long-term success.
- Equity incentive plans: Equity incentives are also used to reward and retain key employees, often in the form of stock options, restricted stock units or phantom stock. These options allow employees to buy shares at a discounted rate or grant them stock at a later date, which can significantly increase their motivation to contribute to the company's success. Vesting schedules are similarly applied to these equity incentives, ensuring that employees remain with the company for a longer period before they can realise the full value of their compensation.
- Earn-out agreements: For founders or key employees, especially in cases of acquisitions or company exits, an earn-out structure may be used. This requires key individuals to meet performance milestones post-sale or acquisition in order to receive additional compensation. It aligns their interests with the long-term growth of the company, encouraging them

to ensure the company's continued success after a major event.
- Bonuses and performance-based incentives: In addition to equity-based incentives, cash bonuses or performance-linked incentives are frequently included in founders' and key employees' compensation packages. These bonuses are often tied to specific company milestones, such as revenue targets, successful funding rounds or operational goals. They serve as an immediate financial reward while promoting alignment with the company's overall objectives.
- Non-compete and non-solicitation clauses: Founder's and employee contracts often include non-compete and non-solicitation clauses, which prevent individuals from starting a competing business or soliciting employees after they leave the company. These clauses further ensure that the company's key talents remain committed to its success in the long term.
- Cultural alignment: Beyond the financial and contractual tools, company culture and the vision for the future are crucial factors in ensuring long-term commitment. When founders and key employees share a common goal and feel a sense of ownership and purpose in the company, their dedication is often as strong as the financial incentives.

5.2 Securities

Tools and Terms for Incentives

In Argentina's venture capital industry, equity drives incentives. Incentive units suit LLCs, while stock options and restricted stock awards fit corporations. Companies retain repurchase rights on unvested shares, sometimes vested ones too, priced by termination type. Incentives might apply to local or holding entities, balancing retention with structural needs.

In Argentina, start-ups and growth companies often use equity-based incentives to align the interests of key employees and founders with the company's success. Similar to international practices, there are key instruments employed in these types of arrangements, such as incentive units, stock options and vesting periods.

5.3 Taxation of Instruments

Incentive Pool and Tax Considerations

In Argentina, the design of incentive plans for founders and employees is strongly influenced by labour laws and tax regulations. One of the main considerations is whether the plan could be considered as *"remuneratory"* benefit, which would subject it to labour taxes upon the issuance of equity to employees. The labour law imposes limitations on payments in kind, capping them at 20% of total compensation, which can discourage companies from offering equity-based incentives to employees.

Given these constraints, many companies in Argentina structure their incentive plans in ways that minimise labour contingencies. This typically involves the use of innovative frameworks that allow founders to grant shares to employees while reducing the tax and labour-related risks. In recent years, there has been a trend of creating plans that are more favourable to both the company and employees by finding creative solutions to reduce the fiscal and labour burden.

While the incentive plans may not always take the same form as those in jurisdictions like Delaware (eg, stock options), Argentine founders and companies are increasingly exploring these alternatives to strike a balance between incentivising employees and managing tax risks.

5.4 Implementation

Series A rounds often allocate 10% of equity for employee pools, demanded by investors to keep teams driven. Investors generally request this allocation, as they want to ensure that the key team (founders and employees) is incentivised to achieve future goals. This percentage may vary depending on the round and the specific agreement, but 10% is the most common.

The equity incentive pool is typically established before or within the framework of the investment round. During the investment round, the terms of the pool are negotiated, and it is crucial for investors to avoid dilution from this equity allocation. In this context, if the incentive plan is agreed upon before the investment round, Series A investors often request that the percentage be deducted from the pre-money valuation to ensure they are not diluted by the incentive programme. However, in the case of SAFEs, investors are not diluted because the equity percentage is set post-investment round.

On the other hand, if there are future investment rounds, the expansion of the employee pool may dilute both founders and existing investors, as these pools typically increase as the company grows and needs more incentives to attract and retain key talent.

6. Exits

6.1 Investor Exit Rights

Exit Strategies and Liquidity

Shareholder rights in exits

Exit terms in Argentina echo National Venture Capital Association (NVCA) norms, featuring tag-along and drag-along rights, plus first refusal on share transfers. Triggers like IPOs, trade sales or liquidations define exit paths, adjusted for Argentina's rare liquidity events. For this reason, some adjustments may have been made to the market practice, but overall, the investor protections and exit rights tend to align with global standards in venture capital.

The standard transfer restrictions usually apply to ensure that shareholders cannot transfer their shares without offering the opportunity to the other shareholders to buy them first (right of first refusal). Exit triggers are commonly defined in terms of an IPO, a trade sale or a liquidation event, typically outlining the conditions under which these events can occur and the rights of investors and founders.

6.2 IPO Exits

In Latin America, IPOs are very rare, and the number of IPOs and exits has decreased considerably in recent years. This is mainly due to economic instability, volatile markets and the lack of available capital.

The M&A sector and exits are seeing limited activity and IPOs are even less common, while the trend has been towards more early-stage exits rather than IPOs. For timeline considerations, early-stage and growth-stage exits are common, where companies are still scaling but have reached a point where an acquisition by a larger company can accelerate growth or provide strategic benefits. For example, large tech companies have previously acquired early-stage tech teams that implemented salesforce solutions. The need for rapid integration of technology teams has driven this trend, as companies sought to expand their global network, especially when the exchange rate was favourable.

When it comes to listing venues and offering structures, in Latin America, companies typically

look for international exchanges, like the NYSE or NASDAQ for IPOs.

6.3 Pre-IPO Liquidity

Secondary Market Trading and Liquidity Challenges in Argentina

Argentina needs secondary market for liquidity, but strict *Comisión Nacional de Valores* (CNV) rules, market volatility, and a risk-averse culture stall progress. Private funded companies offer an alternative, yet legal limits keep trading informal. Many start-ups target US listings or Brazil's BOVESPA for better liquidity options.

In Argentina, there is a tangible need for a secondary market to facilitate liquidity, particularly for early-stage investors and employees. However, several challenges prevent this from becoming a reality.

- Regulation: The main hurdle is the regulation surrounding public offerings of securities. The CNV has stringent rules that prevent start-ups from offering shares publicly unless they go through a lengthy and bureaucratic process, which is not ideal for the fast-paced nature of start-ups.
- Volatility: The Argentine market is highly volatile, which further discourages secondary market trading. Investors are reluctant to participate in a market where liquidity is low and risk is high. Without a public offering, it is difficult to create a secondary market with enough volume to attract substantial investment.
- Cultural issues: There is a lack of investor culture in Argentina, with the public typically investing in low-risk ventures. The desire to gain substantial returns in a short period of time (eg, a small investment turning into millions) contributes to this issue.

A potential solution could be programmes like the *Plataformas de Financiamiento Colectivo* (PFCs), which are similar to trust-based portfolios. In this structure, the fund manager acts as the fiduciary, and it allows investors to sell their shares under certain conditions. While this could address some liquidity concerns, the legal restrictions around public offerings of securities make these secondary transactions informal and not part of a formal market.

Many Argentine start-ups aim to go public in the US market, where there is greater valuation potential and a more robust capital market. Brazil also has a more developed capital market with BOVESPA, making it easier for companies to provide liquidity options for their investors.

There is a clear demand for a secondary market in Argentina, but due to regulatory restrictions on public securities offerings, this market remains informal and underdeveloped. More facilitation of secondary liquidity programmes would help, but without changes in the regulatory framework, the market will continue to face significant barriers.

7. Regulation

7.1 Securities Offerings

Legal and Regulatory Considerations

Rules governing venture capital offerings

The *Comisión Nacional de Valores* (CNV) oversees private securities offers, but Argentine start-ups rarely list locally. In practice, most entrepreneurs in Argentina do not list their companies on the local market. Instead, their IPOs are usually governed by SEC regulations from the United States, not by the CNV.

One of the biggest online marketplace and e-commerce platforms in Latin America went public but did not issue Argentine CEDEARs (Argentine depositary certificates). Instead, investors were required to open accounts with US brokers. This regulatory framework creates a significant opportunity for investors in Argentina. Given the lack of liquidity in the local market, the valuations of Argentine start-ups are very competitive, providing excellent price-quality relationships. Investors can acquire world-class teams for a relatively low cost.

Additionally, due to the favourable conditions in Argentina, Brazilian funds, which typically invest only within Brazil, have increasingly started to invest in Argentine start-ups. The lower cost of entry and the quality of teams available make Argentina an attractive destination for international venture capital.

7.2 Restrictions

Evolving Regulatory Landscape in Argentina

Foreign venture capital investments in Argentina are often discouraged by legal uncertainty, bureaucracy and difficulties repatriating profits.

Due to these factors, many start-ups in Argentina choose to raise capital through holding companies in jurisdictions like Delaware, which provide legal security, tax benefits and flexibility. In such cases, foreign investors do not face significant local regulatory restrictions.

While foreign investors can invest in Argentine start-ups through a local entity, the regulatory environment is restrictive, and such investments are typically structured via a holding company to avoid the burdens of local regulations. The key issue foreign investors face is the difficulty in repatriating funds from Argentina.

Over the past year, Argentina's government has taken steps toward gradually relaxing currency and capital flow restrictions. The objective is to eliminate most of these limitations by October 2025, provided fiscal targets are met. These regulatory changes aim to facilitate capital movement, including dividend payments and transfers from local operations to holding companies abroad, further aligning Argentina with global investment standards.

It is important to note that early-stage venture capital investments are rarely affected by these restrictions, as dividend distributions are uncommon in the first years. Moreover, experienced teams and investors in Argentina are used to operating in complex environments, often utilising alternative mechanisms to efficiently repatriate funds at real exchange rates through well-structured financial strategies.

In this context, Argentina's combination of exceptional talent, entrepreneurial drive and ongoing regulatory improvements is positioning the country as a key player in the regional venture capital ecosystem. The strengthening relationship with the US, both commercially and culturally, only amplifies these opportunities, making Argentina a market with enormous potential for forward-looking investors.

Trends and Developments

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TCA Tanoira Cassagne is one of Argentina's leading full-service law firms, founded in 2011 and based in Buenos Aires. The firm advises clients across a broad spectrum of industries, with a particular focus on start-ups, venture capital, M&A and capital markets. The firm's venture capital team, the largest in Latin America, consists of over 20 professionals, offering comprehensive legal services in structuring investments, fundraising, cross-border transactions and corporate governance. Based in Buenos Aires, TCA also provides legal counsel to tech start-ups, corporations and venture capital funds in the region. Among the firm's clients in the venture capital space are Galicia, Mural, Rappi, Xapo, Cabify, Bresh, Newtopia, The Yield Lab, Byx Ventures, YPF Ventures, Newtopia, Shefa VC (IRSA), NATAN VC (Bind), Blukap Ventures, Alina VC, Innventure, Panambi Ventures, which receive assistance with a variety of complex transactions and regulatory matters.

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Overview of the Venture Capital Market in Argentina

History and evolution of venture capital in Argentina

The venture capital (VC) market in Latin America is relatively new, taking shape in the late 1990s and early 2000s during the dot-com bubble. In Argentina, VC grew with globalisation and technological advancements, attracting both local and international investors. However, economic instability and financial crises limited its sustained growth.

Initially, the government, NGOs and private organisations (such as Endeavor, IAE Business School, and Universidad de San Andrés, among others) played a key role in fostering innovation and entrepreneurship. As the region was – and continues to be – developing, both countries and entrepreneurs learned how to create, finance and scale global companies. From 2010 onward, with partial economic recovery and the proliferation of tech start-ups, Argentina's VC market strengthened, supported by unicorns like Mercado Libre and Globant, which proved the potential of the sector.

Between 2020 and 2022, Argentina experienced significant growth in VC investments. In 2020, approximately USD330 million was invested in Argentine start-ups. This amount surged in 2021, reaching a record USD2.1 billion across 27 deals, more than a sevenfold increase from the previous year. However, investments declined in 2022, with 54 financing rounds totalling USD480 million. This trend was consistent with the global landscape, where VC investments also experienced a downturn during the same period.

Throughout 2023, VC activity slowed due to a global liquidity crisis. Funding declined, valuations fell and start-ups struggled to close rounds. In 2024, Argentina saw a partial recovery.

Impact of the global crisis and venture capital recovery in Argentina

During the pandemic, the massive liquidity injection from the US to drive digital transformation inflated fintech and tech valuations. The subsequent rise in inflation led the US Federal Reserve to tighten monetary policy, reducing available capital. Latin America, one of the least-funded VC regions, was hit hard as limited partners (LPs) scaled back investments. In Argentina, the downturn was most severe from late 2022 to 2023, with many funds pausing investments until market conditions stabilised. The expected 18-month correction extended to 24–36 months.

By 2024, Argentina's VC ecosystem began to show signs of recovery, driven by strategic sectors such as biotechnology (biotech), agritech and foodtech. Corporate funds such as SF500, GridX, CITES and Sancor Seguros Ventures remained active. Additionally, The Yield Lab secured significant funding from Bimbo and Nestlé, driving its fund III and injecting liquidity into the agrifoodtech sector.

However, not all industries recovered equally. Blockchain, for example, suffered a severe drop in valuations, while fintech adjusted its multiples. Despite a general slowdown in bank investments, players like Galicia Ventures and BYX Ventures (BYMA) remained active.

In early 2024, VC activity picked up, but uncertainty around the US elections slowed new fund and capital commitments. However, Argentina gained traction as an investment destination, especially in lithium, oil and gas, mining and the knowledge economy, leading to increased corporate and VC interest.

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Corporate Venture Capital (CVC) in Argentina

Expansion of CVC and key factors

In recent years, Argentina has established itself as a leader in Spanish-speaking Latin America in the adoption of CVC, surpassing countries like Chile, Mexico and Colombia. This growth is largely due to restrictions on corporate profit repatriation and tax incentives that have encouraged reinvestment in innovation and technology.

Unlike more developed markets, Argentina has not established government-backed start-up investment funds in the past year, leaving large corporations and CVC as the primary drivers of the entrepreneurial ecosystem. Additionally, the absence of a large-scale fund of funds has limited institutional financing options, favouring more decentralised strategies led by private and corporate funds.

Key data on CVC in Argentina

According to the Corporate Venturing Latam 2024 Report, developed by Wayra and Global Corporate Venturing:

- 70% of Argentine CVC funds have launched since 2020, tripling the total number;
- 100% invest in seed-stage start-ups, and 83% also target early-stage start-ups;
- 92% invest in regional start-ups, while 46% also invest in the US and 23% in Europe;
- 62% focused on agtech and foodtech, solidifying Argentina's role as an innovation hub;
- 62% also invest in transport, mobility and logistics; and
- 54% invest in financial services, energy and public services.

The report also identified the main mechanisms used by Argentine corporations to engage with innovative start-ups. These were:

- CVC;
- technology scouting (46%) – active search for tech start-ups to address internal challenges; and
- client-supplier Relationships (40%) – collaboration with start-ups to meet specific business needs.

CVC outlook and opportunities in Argentina

CVC in Argentina continues to grow as more companies look to innovate and manage risks. The consolidation of CVC as a key tool for the development of the Argentine entrepreneurial ecosystem, combined with the need for investment in strategic sectors such as agtech, foodtech, biotech and fintech, presents an optimistic outlook for the coming years. As Argentina moves towards economic stabilisation and growth, CVC is expected to play an increasingly significant role in financing start-ups and new technologies.

Funding Rounds and Trends in Argentina

VC funding rounds in Argentina are primarily made through SAFEs (Simple Agreements for Future Equity), rather than equity rounds. There is currently no active exit or IPO market, leading to longer investment cycles and lower liquidity.

Since 2022, due diligence has become stricter, with investors prioritising traction and actual revenue overgrowth projections. Risk aversion has increased, causing more down rounds and tougher founder and business model evaluations. This trend reflects global shifts towards more sustainable investments after the 2021 VC boom.

Additionally, there has been a growing focus on sustainability and ESG policies. Most VC funds now require full ESG compliance in their investment agreements, as their LPs demand ESG

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reports and oversight committees. Today, there is no clear distinction between impact and non-impact funds.

Investment Fund Structure and Liquidity Strategies

Despite market challenges, many VC funds continue raising capital, launching their third or fourth funds. Most frequently used structures are those in the Cayman, BVI, the US and the UK, taking advantage of their legal flexibility and tax benefits.

As exits decline, funds are extending investment periods and exploring alternative liquidity options for their LPs, such as:

- investment period extensions, followed by automatic renewals;
- secondary vehicles (SPVs) to allow some LPs to exit early; and
- start-up leverage through agreements with strategic clients.

These trends mirror global VC shifts in investment strategy, not just those in Argentina.

Key players in Argentina's venture capital market

The Argentine VC ecosystem continues to evolve, with key stakeholders including the following.

- Organisations and associations:
  (a) IAE Business School, through the NAVES programme, has been the pioneer of the promotion of entrepreneurship in the country; and
  (b) ENDEAVOR, ARCAP and ASEA played a very important role in the VC industry and entrepreneurship promotion.
- Accelerators and incubators: Notable players include CITES, Glocal, GridX, Wayra and SF500, with a focus on agtech, biotech and applied technology.
- Investment funds: Leading funds include The Yield Lab, Grupo Murchison, Pampa Start, Xperiment, Newtopia, BYX Ventures, Draper Cygnus, Innventure, GridX and SF500, which drive investment in key sectors such as agri-foodtech, biotech and deeptech.

Local Context

General overview

Argentina's entrepreneurial ecosystem is well-established but faces obstacles, including a lack of institutional investors willing to take VC risks, with national funding being nearly non-existent. This limits start-up financing and fundraising for VC funds.

Moreover, Argentina faces structural challenges in financing start-ups and VC funds. There is no developed capital market that allows start-ups to access bank financing, nor are there pension funds that can invest in VC funds. This lack of financial tools places our country at a disadvantage compared to both developed and emerging markets in the region. Beyond the *Ley de Apoyo al Capital Emprendedor*, there are currently few specific tax incentives for VCs.

Despite these limitations, Argentina continues to stand out as one of the most dynamic entrepreneurial ecosystems in the world. Foreign investors are attracted by its human capital, which is characterised by their resilience, adaptability and passion, and by its abundant natural resources.

What to Expect in 2025

Looking ahead to 2025, Argentina's VC market is showing signs of growth, with more active funds. In parallel, the government is working on deregu-

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lating markets, with plans to eliminate certain restrictions by October 2025, provided that fiscal targets are met.

In this context, Argentina's entrepreneurial ecosystem has a clear opportunity for growth. Despite economic crises and a lack of VC investment, Argentina has built one of the oldest and most resilient ecosystems in the region, with roots dating back to 1999. This track record demonstrates its ability to grow even under adverse conditions.

A key trend shaping the future of VC in Argentina is the rise of funds dedicated to addressing global challenges. Emerging players like ALINA VC (Future of Work), Panambi Ventures (Mental Health), and Blukap (Blue Economy) are directing capital toward start-ups that tackle some of humanity's most urgent issues. Their growth underscores a broader shift toward impact-driven investment, where financial returns align with meaningful social and environmental contributions.

If, in the coming years, Argentina stabilises its macroeconomics, opens to international markets and reduces tax, the country's entrepreneurial ecosystem has the potential to become one of the most significant in Latin America, driven by its most valuable asset: talent and human capital.

BRAZIL

Law and Practice

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FM/Derraik is a top-tier firm in Brazil's corporate legal market for venture capital investments. Its founding partners were forerunners in venture capital in Brazil, recognised as trailblazers in the venture capital market and for start-ups and having worked in the field since 1998. The firm's partners have more than 20 years of experience in advising start-ups and scale-ups, and are aware of all the challenges faced by entrepreneurs at all stages of their ventures' maturity. FM/Derraik's professionals are able to advise entrepreneurs from day one, through start-up capitalisation stages (acting on behalf of venture capital investment funds, entrepreneurs or the start-up itself) including *"family and friends"*, pre-seed investment, Series A onwards, exits and liquidity events, with superlative valuations. The firm has strong expertise as well as qualified and specialised professionals for meeting all demands concerning innovation, start-ups and tech companies.

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1. Trends

1.1 VC Market

After a couple of years of resilience and consolidation, 2024 showed small signs of growth and VC investor optimism in comparison with 2023.

While capital deployment was still very timid in comparison with 2021, deal volume recovered, particularly driven by local investors in seed and early-stage rounds, as indicated by the 2024 report released by the Association for Private Capital Investment in Latin America (LAVCA).

In 2024, Brazilian start-ups raised USD4.89 billion across 513 financing rounds. According to a report commissioned by Itau BBA and issued by Sling Hub (a data intelligence platform for the sector), Latin American start-ups saw a 37% year-over-year growth in 2024, which is the first annual increase since the 2021 peak. The number of financing rounds, however, decreased in 2024.

1.2 Key Trends

Despite the slight recovery of the VC market in 2024, high interest rates (encouraged by the Brazilian government to contain inflation) and global macroeconomic challenges create an uncertain scenario for the VC market in 2025.

There was a significant increase in the capital raised by start-ups through debt rounds or receivables funds, which shows that typical VC investors are still restrained in their deployment of cash in equity financing rounds. It looks like venture debt and structured financing will remain key tools for start-ups navigating the challenges of fundraising in 2025.

We also expect financings with the participation of a greater number of investors, which will show that investors are still acting with a certain degree of caution, opting to share risks with other players, even if it means lower returns. Discussions involving anti-dilution protections should also gain attention in view of uncertainties for the next couple of years.

1.3 Key Industries

According to the Sling Hub/Itaú BBA report, the fintech industry remained the most dominant sector, accounting for 55% of total investment in Latin America during the 2024 period.

Other notable sectors included:

- energy (13%);
- deep tech (6%); and
- healthtech (3%).

In Brazil, cleantech and agritech are expected to grow and attract significant investment due to sustainable solutions for global markets.

AI-powered start-ups will continue to attract large VC investments due to their capacity to automate and improve business processes.

2. Venture Capital Funds

2.1 Fund Structure

Many players are involved in a typical VC funding structure, including (among others):

- institutional private equity funds on early-stage, growth-stage and late-stage modalities;
- single limited partnership funds with corporations as limited partners (also called corporate venture capitals);
- development fund investors;
- angel investors;

- accelerators and incubators; and
- development agencies.

Private equity funds (*fundos de investimento em participação* – FIPs) are the most widely used types of investors and the main providers of funding to start-ups in the VC industry.

FIPs are mainly governed by their related regulation (*regulamento*), which is registered at Brazil's Securities and Exchange Commission (CVM). Such regulation forms the equivalent of a corporation's by-laws, containing the rights and obligations of the fund, decision-making processes and restrictions.

There are two key and mandatory service providers for FIPs: the administrator and the manager. The administrator is responsible for the legal representation of the fund and for all back-office activities (such as treasury and controller activities, bookkeeping, and compliance with legal requirements and internal policies). The fund manager has the essential roles of defining the fund's strategy, deciding on and monitoring investments, and determining divestments (supported or not by the investment committee).

The regulation also requires auditing by independent auditing firms and the disclosure of relevant information.

2.2 Fund Economics

Participation of Fund Principals in the Economics of VC Funds

Fund initiators, managers or principals can participate in the economics of VC funds in several ways.

Fund principals are mainly remunerated by management fees and performance fees. In VC, these fees are usually established in the *"2 with 20"* format, an expression that summarises the practice of charging 2% per year (calculated on the fund's capital) as administration and management fees, and 20% of the profitability earned by the fund's investors as a performance fee or carry.

- *Management fee:*This fee is typically calculated as a percentage of the capital commitments or the assets under management (AUM), paid to the fund principals for their role in managing the fund's investments. The standard rate is around 2% per annum, though this can vary depending on the size of the fund and the reputation of the management team.
- *Performance fee:*Also known as *"carry"*, this is the share of the profits that the fund principals receive from the investments made by the fund, serving as a performance incentive. *"20% carry"* is standard, meaning that the fund principals receive 20% of the fund's profits after returning the original capital, and sometimes a preferred return to the investors.

Other key terms developed as market practice include the following:

- *Co-investment opportunities:*Fund principals, and sometimes employees, of the management company may have the opportunity to invest their own money alongside the fund in specific deals. This aligns their interests with those of the limited partners (LPs) by their having personal stakes in the success of the investments.
- *Hurdle rate or preferred return:* This is a minimum rate of return (typically between 6% and 8%, as adjusted by inflation) that the fund must achieve before the fund principals can receive their carried interest. It is an investor protection mechanism ensuring that LPs

receive an acceptable return on their investment before the fund principals can share in the profits.

- *Claw-back provision:*This ensures that, if the fund does not achieve a certain level of overall performance, any carried interest paid to the fund principals must be returned. This protects investors from overpaying the fund principals during the life of the fund if early exits provide temporarily high returns that are not sustained.
- *General partner (GP) commitment:*Fund principals are often required to invest their own capital into the fund, typically 1% to 3% of the total fund size. This *"skin in the game"* aligns their interests closely with those of the LPs.
- *Governance and voting rights:*These often include provisions about the governance of the fund, specifying the rights of the LPs to have a say in major decisions.
- *Key-person clauses:* These clauses are triggered if certain key individuals (usually senior fund principals) are no longer actively involved in managing the fund. This can lead to a halt in new investments or even winding-down of the fund if replacements are not suitable.
- *Transparency and reporting requirements:*Regular, detailed reporting on the performance of the fund, the status of investments and the management fee calculations are required to maintain transparency. This includes annual audits and frequent performance reports.

The foregoing mechanisms and terms have been developed to ensure that fund principals are motivated and incentivised towards good performance, while providing investor protection and governance in the VC ecosystem. It is important to note that the specifics can vary based on the fund's structure, its strategy and the regulatory environment in which it operates.

2.3 Fund Regulation

Investment funds in Brazil are classified as condominiums according to the Brazilian Civil Code and are regulated by Resolution No 175 of the CVM, enacted on 23 December 2022. FIPs, in particular, are regulated by Annex IV of said Resolution.

2.4 Particularities

It is very common for VC investment funds to be categorised in accordance with the adopted investment strategy (ie, early-stage, growth-stage, late-stage, Series A, Series B, impact investments and others).

Although many funds are agnostic in terms of industry, some industry-focused funds exist, including for fintech, agritech, cleantech and healthtech.

Reorganisations among funds is the available strategy to accommodate extended average holding periods for investments.

3. Investments in Venture Capital Portfolio Companies

3.1 Due Diligence

Due diligence is an essential element in the process of completing an investment or acquisition.

Start-ups at their initial stages of development are usually subject to fast and less complex due diligence proceedings, since they tend to have had few years of existence and thus have fewer clients or contractual obligations. Due diligence of early-stage start-ups is focused on corporate aspects – ie:

- to analyse the holders of the company's share capital (on a fully diluted basis), as well as intellectual property and regulatory aspects; and
- to ascertain whether the start-up has the necessary assets and licences for the development of its business, as well as the legal certificates confirming it is involved in administrative or judicial proceedings, and the corresponding risk assessment.

For start-ups at more advanced stages of company development, due diligence is deeper and more complex, covering financial and accounting aspects in addition to full legal due diligence, so that investors can identify contingencies (potential or materialised) and whether any mitigation measures can be adopted to address such issues.

3.2 Process

Investment Process and Timing

The timeline for a new financing round in a growth company involving new anchor investors can vary significantly based on several factors, including:

- the complexity of negotiations;
- due diligence requirements;
- the current financial condition of the company; and
- the level of interest among potential investors.

The following is an outline of a typical fundraising process.

- *Preparation phase:* This includes getting the company's financials and corporate structure in order, preparing pitch decks and potentially hiring/working with advisers.
- *Initial discussions:* The company begins to approach potential new investors (anchor investors) and re-engages existing investors to gauge interest.
- *Term sheet:* This involves negotiation and outlining the key terms of the investment.
- *Due diligence:* This begins concurrently with or following the execution of the term sheet. New investors will scrutinise the company's financial, business model, market potential, legal, compliance and other critical aspects.
- *Legal documentation and final closing:* After agreeing on a term sheet and satisfactory due diligence by the investor, legal documents are drafted, negotiated and executed.

Overall, for a priced equity round, a typical timeline to close is three to six months. For a convertible instrument, this could be as little as one to three months.

Relationships Between Various Parties

Existing versus new investors

Existing investors may have different interests compared to new investors, particularly regarding valuation, dilution and the strategic direction of the company. Existing investors typically want to protect their stake and to ensure continued influence, while new investors may push for terms that favour their new injection of capital.

New investors might also negotiate for preferential terms such as liquidation preferences or anti-dilution protections, which can lead to conflicts with existing shareholders.

Joint versus separate counsel

Often, each party or group of parties with aligned interests usually has separate legal counsel to ensure their interests are fully represented. However, in some cases, particularly in smaller rounds or when parties have pre-existing alignments, joint counsel may be used. A group of investors may also share the same legal counsel.

Majority requirements versus consent of all existing investors

The most common form of investor consent is majority approval, especially for key decisions such as additional equity issuance or other matters with dilution consequences. However, in some cases, protective provisions for a specific investor or group of investors are negotiated.

3.3 Investment Structure

In early-stage financings in Brazil, convertible debt instruments are much more common than equity issuances.

Convertible Debt

The most widely used debt instruments in the Brazilian VC industry are convertible loans and convertible debentures. The loan agreement or debenture deed will establish the obligation of the start-up to pay the debt on the maturity date, with the option (or obligation) for the investor to contribute its credit into the start-up's share capital, subject to certain future events and as contractually established.

Such instruments are widely used for three main reasons:

- for the investor to avoid potential liability for the debts of the company – although shareholders are generally subject to limitation of liability and separation of assets of the company, cases where the shareholders are held liable for the company's debts are common;
- as a creditor of the company, the investor will have a more senior-rank position than the shareholders for receiving liquidation assets of the company, in the event of bankruptcy; and
- early-stage start-ups are still poorly structured in terms of financial and operating metrics as regards using traditional valuation methods to enable calculation of equity interest.

Please note that the investor's ultimate goal is to have the debt instrument converted into equity, typically preferred stock, under certain conditions (such as a subsequent financing round – often a Series A round), provided the start-up is progressing satisfactorily and moving forward on its journey. It is very unlikely that a successful start-up will repay the loan to the investor, as if it were a traditional lender.

The key features of a debt instrument include:

- conversion discount – provides a discount on the price per share when the loan/note converts in the next financing round;
- valuation cap – sets a maximum company valuation at which the loan/note will convert, protecting investors from too much dilution;
- interest rate – accrues until conversion;
- maturity date – specifies when the loan/note must be repaid or converted; and
- main rights of the investor after the conversion, such as protection against dilution, liquidity rights and protective provisions.

Simple Agreement for Future Equity (SAFE)

The SAFE is a contract model designed and popularised by the US accelerator Y Combinator (YC) for early-stage investments. It is widely used in the USA and for start-ups' investment deals structured offshore (usually through Cayman Islands and Delaware entities).

SAFEs do not have the nature of debt, which means that the investment must necessarily be converted into equity interest (upon the occurrence of a liquidity event) or cancelled (in which case the investment is written off). A SAFE has a standard model, which reduces the need to

negotiate the terms of the investment and, consequently, the transaction costs.

Choosing the right instrument involves considering the current valuation, the expected future financing needs and the strategic goals of the company.

Note that Complementary Law Bill No 252/2023 is currently being debated and voted on at the National Congress, which would create a new contractual form for VC investments in Brazil similar to the SAFE, called the Convertible Capital Investment Agreement (CICC).

3.4 Documentation

Deal Documents

In a growth company's financing round, several key documents are typically required to successfully negotiate and close the deal. The exact nature of these documents can vary depending on the jurisdiction, the structure of the financing (eg, equity versus debt) and the stage of the company. However, certain documents are almost always part of such transactions, as follows.

Term sheet

This is a non-binding document outlining the key terms and conditions of the investment. It serves as the basis for drafting detailed and definitive legal documents.

Investment agreement (subscription agreement or stock purchase agreement)

In an equity financing round, this binding and definitive agreement details the terms under which the securities are issued to the investor, including:

- the purchase price;
- representations and warranties of the company;
- conditions for closing; and
- covenants of the parties involved.

Shareholders' agreement (or investors' rights agreement)

This agreement outlines the rights and obligations of the shareholders post-investment, including:

- governance provisions;
- rights of first refusal;
- drag-along and tag-along rights;
- voting rights; and
- information rights.

Amended and restated articles of incorporation (or memorandum and articles of association)

When the company is structured offshore and the financing deal is made at the Cayman company level, the transaction documents would include amendment to the company's articles of incorporation, to reflect the new capital structure and any rights or preferences attached to the newly issued shares.

Disclosure schedule

This document complements the investment agreement by disclosing exceptions to the representations and warranties made by the company and the founders in the stock purchase agreement. It is critical for risk allocation between the parties based on due diligence findings.

Frequently used templates

No standard templates are used in deals conducted mainly in Brazil. In other jurisdictions with a more developed start-up and VC ecosystem, certain organisations or legal entities have pro-

vided standardised templates for streamlining financing rounds, such as:

- Y Combinator's SAFE;
- National Venture Capital Association (NVCA) models widely used in the USA;
- British Venture Capital Association (BVCA) models for VC and private equity transactions in the UK; and
- Australian Investment Council (AIC) models.

3.5 Investor Safeguards

In VC financing, investors often negotiate for specific terms to protect their investment in *"downside scenarios"*, such as the winding-up of the company. Such terms include the following.

Liquidation Preference

This is perhaps the most critical term for protecting VC investors in a downside scenario. Liquidation preference ensures that VC investors are paid out before common shareholders (including founders and employees) in the event of a liquidation, sale or dissolution of the company.

Sometimes, this is structured as a multiple of the original investment (eg, 1x, 2x). Liquidation preference provisions can also include participation rights, in which case investors have the ability to not only recover their initial investment but also to participate in the distribution of the remaining assets alongside common shareholders.

Down-Round Anti-Dilution Provisions

Anti-dilution provisions protect investors from equity dilution in the event that new shares are issued at a lower price than the price per share paid by the investor. There are typically two forms, as follows:

- *Full ratchet anti-dilution:* This form of anti-dilution adjusts the conversion rate of preferred stock to the price at which new shares are issued, regardless of the amount of new capital raised. This is quite protective for investors but can be very punitive for existing shareholders.
- *Weighted average anti-dilution:* More common than *"full ratchet"*, this method uses a formula to adjust the conversion price based on the number of new shares issued and on the price at which they are sold at each financing round. It is generally seen as more equitable than the full ratchet method.

Pre-Emption or Subscription Rights

Pre-emption rights, also known as rights of first refusal, allow existing investors to maintain their percentage whenever new shares are issued. This is crucial for investors wishing to avoid dilution in subsequent financing rounds. The terms specify how investors can participate in future rounds, typically requiring them to act within a certain timeframe when new shares are offered.

In view of recent changes in market conditions, some investor safeguards, such as liquidation preference and anti-dilution terms, have been perceived as more start-up friendly.

3.6 Corporate Governance

Protective Provisions and Governance

VC investors often negotiate for specific rights that allow them to exercise significant influence over the management and corporate affairs of the companies they invest in.

Effective governance rights for investors help ensure that the company is managed in a way that aligns with its long-term strategic goals and protects the interests of all shareholders, aiming at profitability or a successful exit. The challenge lies in establishing governance rules that are compatible with each stage of the start-

up's development. More robust governance is secured when the company is structured as a corporation (rather than as a limited liability quota company). For this reason, VCs normally require start-ups to be transformed into corporations prior to the conversion or equity investment.

Board of Directors

Significant influence is generally obtained by the investor (or group of investors) having the right to appoint one or more members to occupy a minority of the seats on the board of directors. It is important to note that VC investments usually involve minority stakeholding in the share capital, in such a way that the objective is not to take control of the company's management. The majority of the seats on the board remain occupied by the founders. It is also common to see investors appointing people to act as *"observers"* of the board. Such investors generally do not have a significant stake in appointing an effective member, but still wish to appoint a representative (without voting rights) to follow the board meetings.

Protective Provisions

These provisions typically require that the investor's consent is needed for certain actions (veto rights), such as:

- changes to the rights attached to the investor's preferred shares;
- changes to the company's charter or by-laws;
- issuance of new shares or new classes of shares; and
- the company's undertaking significant indebtedness and entry into new business areas, or discontinuation of significant operations.

Information Rights

VC investors are often entitled to regular, detailed financial and operational reports from the company. These rights can include quarterly and annual financial statements, budgets and audit reports.

Right of First Offer/First Refusal/Pro Rata

Such rights enable investors to participate in future funding rounds, to maintain or increase (super pro rata) their equity position.

3.7 Contractual Protection

Representations and Warranties

The company and the founders provide representations and warranties in the investment agreement, making a series of statements in favour of the investor regarding the start-up and its business, in order to provide the investor with *"picture"* of the start-up's situation at the time of the investment. Typical representations and warranties provided in relation to the company include the following:

- organisation and good standing – attesting that the company is organised, validly existing and in good standing under the laws of its jurisdiction;
- authorisation – attesting that all corporate actions required for the authorisation, execution and delivery of the investment agreements have been taken;
- use of proceeds – the company agrees to use the proceeds of the investment as stipulated in the agreement;
- financial statements – attesting that the financial statements provided are true and complete and fairly represent the financial condition of the company;
- compliance with laws – attesting that the company is in compliance with all applicable laws and regulations;

- intellectual property – attesting that the company owns or has the right to use all intellectual property necessary for its business, free of liens or encumbrances;
- litigation – information confirming that there is no litigation pending or threatened that could materially affect the company and/or the investment; and
- labour and tax compliance – confirming that the start-up is in good standing from a labour and tax point of view.

The content of the statements varies in each case, depending on the characteristics of the start-up and on the result of the due diligence carried out by the investor.

Indemnification

In the case of breach of any representations, warranties, covenants or undertakings, the recourses available to the investor typically include the following:

- indemnification – the defaulting party may be required to indemnify the indemnified party for losses resulting from the breach;
- right to cure – some agreements may allow the breaching party a certain period to rectify the breach before further legal actions can be taken;
- termination of the agreement – for severe breaches, the non-breaching party may have the right to terminate the agreement; and
- specific performance or injunction – in cases where monetary compensation is inadequate, a court order may be sought to compel the breaching party to perform its obligations or to refrain from certain actions.

4. Government Inducements

4.1 Subsidy Programmes

Several types of incentives or programmes are provided by the government, to incentivise the development of start-ups and entrepreneurship in Brazil, including:

- differentiated tax regimes (*simples nacional*, a tax regime devised to simplify computation and compliance for small entrepreneurs);
- tax incentives for certain research and development activities;
- tax incentives focused on specific industries or regions of Brazil; and
- initiatives of national or regional development agencies and entities, such as the creation of Criatec's investment funds by the Brazilian National Development Fund (BNDES), effectively deploying capital in the VC environment.

It is also worth mentioning the 2021 New Legal Framework for Start-Ups (*Marco Legal das Start-ups*), which presents various measures for stimulating the creation of innovative companies and establishes incentives for investments through the improvement of the business environment in Brazil.

These initiatives aim to:

- create a favourable environment for the emergence and growth of start-ups;
- improve the competitiveness and innovation rates of companies;
- increase the number of enterprises;
- promote income and employment generation; and
- expand the supply of innovative goods and services in Brazil.

Many state governments also support or fund start-up accelerators and incubators, which provide equity financing, mentoring and resources in exchange for a small equity stake.

4.2 Tax Treatment

No specific tax treatment applies for growth, start-up or VC fund portfolio companies in Brazil. They are treated just like any other company, and the tax rules applicable to such company will vary according to the type of tax regime chosen: real profit, deemed profit or *"SIMPLES"*.

Companies opting for real profit can deduct necessary and usual expenses of their operating activity from the tax basis of their corporate income tax and social contribution on net profit. In addition, companies that invest in technological innovation can fill out their tax deduction basis by investing in technology development and technological innovation projects. This was established by Law No 11,196 of 2005, known as the *"Good Law"* (*Lei do Bem*).

4.3 Government Endorsement

No major initiatives specifically designed to increase the level of equity financing activity in the VC industry are conducted by the Brazilian government, though there are many programmes of lower relevance.

5. Employment Incentives

5.1 General

Employment Incentives

Securing the long-term commitment of founders and key employees is crucial for the stability and success of a start-up. This commitment is typically achieved through a combination of contractual agreements, equity incentives and cultural strategies designed to align the interests of the founders with those of the key employees, and with the growth and goals of the company – thus creating a sense of ownership for such individuals.

Equity incentives

Usually, a primary tool for ensuring the long-term commitment of founders and key employees is through long-term incentives and equity-based compensation, which focus on the appreciation of the value of the company's shares over time.

Cultural and non-financial incentives

Developing a strong company culture and providing a positive work environment are also vital. Measures aligned with those objectives include:

- development of growth opportunities for professionals, and training and educational programmes that help individuals advance their careers within the company;
- regular acknowledgement of employees' hard work and achievements; and
- work-life balance, through initiatives that offer flexible working conditions, wellness programmes and family-friendly policies.

Exit opportunities

Clearly defined exit strategies for founders and key employees can also play a role in their commitment. These might include lucrative buyout options or favourable terms upon the sale of the company.

By combining these strategies, ventures can effectively motivate founders and key employees towards dedicating themselves to the company's mission and objectives over the long term, minimising turnover and maintaining continuity in leadership and expertise.

5.2 Securities

Types of Long-Term Equity-Based Incentives

The most-seen types of equity-based incentives in the Brazilian VC market are as follows.

Stock options

Here the participant is granted, or purchases, options to acquire equity interest in the company at a future time, for a predetermined price (strike price). For the effective exercise of this right, the participant must comply with certain conditions, which may relate to time (vesting), achievement of goals or occurrence of a liquidity event, among others.

Partnership

Here the company offers the participant the opportunity to become a partner, acquiring a direct or indirect stake in the company, at market value. Payment of the purchase price is generally made in instalments.

Restricted stocks or units

Restricted shares, called RSAs or RSUs (*"restricted share awards"* and *"restricted share units"*) represent a type of long-term incentive according to which there is no investment or financial consideration on the part of the participant. The company grants the shares or units free of charge, in advance or after the fulfilment of a certain period (vesting). Unlike options, which must be exercised, RSUs are typically converted directly into stock upon vesting, which may then be subject to further mandatory selling periods or holding requirements. This is also a strong incentive for employees to remain with the company, as they gain full ownership of the shares after the vesting period.

Phantom shares

These instruments aim to fulfil the same economic purpose as options or restricted stocks, but with settlement in cash and not in shares.

The choice of long-term incentive that best suits the start-up must take into account a number of factors, such as:

- how employees are hired;
- the business model; and
- in particular, the company's stage of development.

Standard Terms

Vesting schedule

Stock options or similar instruments usually vest over a period of time to encourage employees to remain with the company. A common vesting schedule is for four years, with a one-year cliff (meaning that no vesting occurs until the end of the first year), followed by monthly or quarterly pro rata vesting.

Exercise period

After vesting, employees typically have a set period during which they can exercise their options – eg, ten years from the grant date.

Exercisability

Options are generally exercisable once vested, but may have additional conditions based on company performance or milestones.

Claw-back provisions

Some incentive plans include claw-back provisions that allow the company to reclaim the value of equity compensation under certain conditions, such as for misconduct or breaches of contract by the employee.

Other clauses

Formal employment agreements executed with founders and key employees often include other clauses designed to ensure or protect their long-term involvement, including non-compete and non-solicitation clauses.

5.3 Taxation of Instruments

Taxation for Long-Term Incentives

Brazilian legislation still does not have specific regulations regarding an incentive pool for founders and employees. However, labour and tax jurisprudence has tried to introduce relevant definitions. So far, key decisions have related to companies in the traditional economy, with a high level of maturity and consolidated in the market, and whose main objective was to bring prestige to their employees or top executives.

Based on the foregoing, the key tax factors to consider are as follows.

Nature of incentive plans

The legal nature of the incentives will determine the tax burden levied on it. Depending on the characteristics of the incentive plan, it may be of a mercantile or compensation nature.

In the start-up ecosystem, incentive plans have the purpose of attracting and retaining people who have been important for the company's development since the beginning of the company, with little market exposure and low revenue. Therefore, an incentive plan becomes a mechanism whereby the beneficiary assumes the risk of the start-up's business. As such, a start-up's incentive plan would offer more subsidies and characterise them as contracts of an effectively mercantile legal nature.

Tax rates

If the incentive plan is of a mercantile legal nature, the income tax levied will be a progressive levy of between 15% and 22.5%. If it is of a salary nature, income tax will be levied based on the progressive personal income tax table, up to 27.5%, as well as a social security contribution of at least 20%.

Tax basis

One difficulty that is encountered is establishing the tax base – whether this is the value paid/assigned to the founder/employee at the time of the grant, or the value after vesting. The latter is particularly difficult where it is hard to establish the market value of a start-up's share at the time of granting, or even for the vesting exercise.

5.4 Implementation

Option Pool

The processes for implementation of an investment round and the setting up of an employee incentive programme are intrinsically related. During the negotiations of an investment round, the parties evaluate the company's needs, including how much equity is expected to be allocated for employee incentives (for both current and future employees). From the investors' perspective, a robust employee incentive programme is valuable for driving the company's growth.

The size of the employee stock option pool is typically negotiated as part of the investment terms. If the existing pool size is not sufficient to meet future hiring needs, investors may require an increase of the pool size, with dilution effects on the shareholders immediately prior the completion of the investment.

6. Exits

6.1 Investor Exit Rights

Sales to strategic buyers or other institutional investors comprise the vast majority of exit forms for VC-backed start-ups in Brazil, though the number of successful IPOs in past years has increased.

Exit-related provisions in shareholder agreements to regulate those processes include the following.

Drag-Along Rights

Certain shareholders (usually majority shareholders) can force other shareholders to participate in the sale of the company. In the VC industry, a typical drag-along clause states that if shareholders holding a qualified majority of the share capital (eg, 70%) wish to sell their shares to a third party, they may require the other shareholders to include their shares in the sale, under the same conditions offered by the third party. To protect themselves from unfair *"forced"* sale, some investors require the inclusion of a contractual provision whereby they can only be *"dragged"* into a sale transaction if the price per share offered by the third-party purchaser is higher than a certain multiple of the price per share paid by the investor.

Tag-Along Rights (Co-Sale)

These are used as a protection mechanism for minority shareholders, by giving them the right to join in a sale of shares by majority shareholders on the same terms. This ensures that they can benefit from the same terms as the exiting, selling shareholders. VC investors require tag-along rights in investment rounds, as an alternative to pre-emptive rights. Once the lock-up period is over, if the founders wish to dispose of their shares and have received a binding offer from a third party, they must notify the investors that, within a certain period, they may alternatively:

- exercise the pre-emptive right and acquire the founders' shares; or
- exercise the tag-along and sell their shares together with the founders' shares.

Other Transfer Restrictions

Other transfer restrictions include right-of-first-refusal (ROFR) and right-of-first-offer (ROFO) provisions, giving the non-selling shareholder a prior-refusal right or first-offer right, as applicable, in the event of a sale of shares by the selling shareholder.

Exit Triggers

Exit triggers are specific conditions defined in shareholder agreements that activate certain rights or obligations concerning an exit event. Sale of a company's control (often defined as a transaction where more than a certain percentage of the company's shares are sold, or where there is a sale of substantially all assets of the company) and IPOs are typical exit-triggering events.

Understanding and negotiating these provisions requires careful consideration of the dynamics between different groups of investors and the founders, as well as of the strategic goals of the company. When properly structured, these provisions ensure that all parties can realise the value of their investment under fair and equitable conditions during an exit.

In Brazil, mergers and acquisitions continue to be the vast majority of exits for start-ups, as opposed to the almost non-existing IPOs. Hence, investors' rights such as drag-along and tag-along provisions are often the subject

of negotiation and a point of concern for the investors.

6.2 IPO Exits

In spite of the slight increase in the number of exits through IPOs in Brazil, the country's capital market deals are pretty modest when compared with developed jurisdictions.

The whole process is time-consuming and costly. Preparation for an IPO takes around 12 to 18 months, and requires a certain mindset and operational change, in view of the numerous compliance and regulatory requirements.

6.3 Pre-IPO Liquidity

There is no legal provision for secondary market needs in the context of an IPO. In fact, this is a major problem for the development and growth of the Brazilian capital market, which is still incipient in this respect and where there is not enough demand. There is no legal provision for promoting or stimulating liquidity of the secondary market. Nonetheless, there are sometimes certain acquisition priorities in employee IPOs as well as preferences for primary offering versus secondary offering.

7. Regulation

7.1 Securities Offerings

Under the applicable laws of Brazil, an offering of securities is deemed to constitute *"public offering"* whenever:

- the issuer publishes any form of advertising (or materials that may be deemed to constitute advertising) or announcement expressing the issuer's intention to sell securities to the general public in Brazil;
- the issuer hires brokers or agents, or uses employees, to search for underwriters or purchasers for the securities; or
- if the trading of the securities is to be carried out in a public space, the issuer uses public communication devices.

An important aspect in determining whether a placement constitutes *"public offering"* is the public sought by the offer – ie, whether the offer is directed towards the general public. The CVM defines *"general public"* as any class, category or group of people, even if individualised, besides those who have had a regular and previous relationship with the issuer. Therefore, the offer is deemed *"public"* whenever it is not possible to identify or individualise the investors to whom it is directed.

If any offer is made within Brazil, such distribution must be conducted by entities authorised to do so by the CVM.

7.2 Restrictions

Foreign direct investment (FDI) restrictions are more common in the real economy than in relation to technology companies. However, some existing FDI regulations may apply to growth/portfolio companies of foreign VC investors, as follows.

Sector-Specific Restrictions

Certain sectors may be sensitive or strategic, requiring special approval or outright prohibiting foreign investment. Defence, telecommunications, real estate (rural areas) and gaming are examples of sectors that are subject to FDI restrictions. Most of the time, the restrictions are limited to a cap on the percentage of ownership that foreign investors can hold in domestic companies; therefore, minority interests of VC investors may not be affected by such limitations.

Banking and Financial Regulations

Participation of foreign investors in the capital of financial institutions in Brazil is subject to authorisation, pursuant to an international treaty providing for reciprocity, or, in the event that such investment is recognised by the Brazilian government as being in Brazil's best interest, through the enactment of a Presidential Decree.

There are no restrictions on FDI into fintechs that do not qualify as financial institutions (SCDs or SEPs). However, even for fintechs that qualify as financial institutions (credit fintechs), a Presidential Decree (with a general ruling) was issued to stimulate the development of the industry in Brazil, establishing that foreign capital participation of up to 100% in credit fintechs is, in general, in the best interest of the government, as it favours competition and technological innovation in the industry.

It is crucial for foreign investors to consult with legal experts in the target jurisdiction, to understand the specific legal requirements and to ensure compliance with all applicable regulations. This due diligence is essential not only for legal compliance but also for assessing viability and potential investments in foreign markets.

Trends and Developments

Contributed by:
Fernanda Levy
FM/Derraik

FM/Derraik is a top-tier firm in Brazil's corporate legal market for venture capital investments. Its founding partners were forerunners in venture capital in Brazil, recognised as trailblazers in the venture capital market and for start-ups and having worked in the field since 1998. The firm's partners have more than 20 years of experience in advising start-ups and scale-ups, and are aware of all the challenges faced by entrepreneurs at all stages of their ventures' maturity. FM/Derraik's professionals are able to advise entrepreneurs from day one, through start-up capitalisation stages (acting on behalf of venture capital investment funds, entrepreneurs or the start-up itself) including *"family and friends"*, pre-seed investment, Series A onwards, exits and liquidity events, with superlative valuations. The firm has strong expertise as well as qualified and specialised professionals for meeting all demands concerning innovation, start-ups and tech companies.

Author

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Challenges of Corporate Venture Capital in Brazil

The number of corporate investors across the globe has tripled in the last decade, and they are now part of one in every six start-up funding rounds, says the research published by Global Corporate Venturing in February 2025. In Brazil, corporate venture capital (CVC) has gained significant traction over the past years as well, as established companies seek innovative start-ups to drive strategic growth.

While venture capital (VC) has suffered a reduction in liquidity in the last couple of years after the VC hype in 2021 and 2022, enthusiasm for the CVC ecosystem seems to continue, according to data released last year by the Brazilian Association of Private Equity and Venture Capital (ABVCAP). Brazil has a clear competitive edge in sectors such as fintech and agribusiness, offering a vast opportunity for the development of CVC investments in start-ups with potential to scale and grow.

However, as the Brazilian CVC ecosystem matures, notable challenges arise. At the same time as managers are recognising the strategic growth potential for corporations, they are also acknowledging that, without proper structuring, governance and clear strategies that are aligned with the corporate objectives, CVC may face difficulties, especially in the coming years, as high interest rates, tax reform and political insecurities tend to shift the focus towards more concrete results and financial gains in the short term.

In this article, we explore the complexities of CVC in Brazil, focusing on the need to define clear and long-term strategies aligned and engaged with the corporation's goals and business areas, to structure a diverse and integrated CVC team and to master the intricate dynamics of value creation, among other insights.

Clear strategies and alignment of interests

Corporate investors often struggle with defining clear strategic objectives when engaging in CVC. CVC investments are primarily designed to foster innovation and explore emerging technologies while aiming for financial results.

Corporations may approach CVC with a strategic mindset, while start-ups may prioritise growth and independence. If expectations are not aligned, conflicts may arise, affecting the success of the investment and impacting the future of the start-ups.

If the CVC operations are not clearly in line with the strategies of the parent company, this can lead to misaligned expectations between the corporate leadership and their venture capital teams, potentially hindering efficient execution. In several cases, the corporate leadership might not be familiar with the risks intrinsic to venture capital activities, which ends up generating friction and misaligned expectations in the decision-making processes, affecting the development of the start-ups.

One of the main sources of misaligned strategies is a lack of separation between the roles of the CVC and those of other areas of the company connected to the innovation initiatives, such as business development, M&A or venture building. For example, the use of traditional M&A or project management mindsets in a CVC context can lead to disastrous consequences, lack of trust in the CVC operations being the most important one. This overlap or confusion between the roles proper to each function can lead to inefficiency and loss of valuable opportunities.

Corporate investors' leadership

Corporate investors' leadership plays a vital role in defining and making clear, both internally and externally, the objectives and strategies of the CVC. Start-ups operate in an environment of fast launches, often pivoting when necessary to adapt to market conditions. Large corporations, however, tend to favour stability, structured processes and predictable results. The divide between these cultures can prevent productive collaboration, limiting the benefits of corporate-backed venture investments.

One key takeaway is the understanding that the involvement of the corporation's executives cannot be limited to the initial stages of the CVC development process. Frequent close follow-up with the involvement of the company's leaders is essential, so that these executives understand the logic of venture capital vis-à-vis the perspective of the corporate investors and can be prepared to make wiser decisions based on correct assessments.

Commitment from leadership is crucial for maintaining CVC initiatives beyond short-term financial pressures. Traditional venture capital firms are structured to maximise financial returns, while CVCs typically prioritise strategic value over pure profitability. This difference can sometimes lead to lower-than-expected financial gains, which must be foreseen from day one from the corporation's viewpoint. Short-term expectations is another hurdle CVC managers must overcome, as described below.

Define long-term goals

CVC should be viewed as a long-term strategic initiative with significant associated risks.

A CVC programme's success hinges on a long-term vision. When establishing a CVC programme, it is important to establish a minimum time for maturation, as the full benefits of investments in start-ups and emerging technologies take time to materialise. Establishing clear long-term goals ensures that CVC initiatives remain strategically aligned and resilient in dynamic market conditions.

Successful CVC programmes require time to integrate within corporate structures, ensuring executives, business units and start-up partners align on expectations. Corporate investors that expect quick results in CVC operations, especially financial results, will certainly end up frustrated.

Unlike traditional investments focused on immediate financial returns, CVC operates with a long investment horizon, often spanning multiple years. The true value of corporate-backed start-ups unfolds as they refine their technologies, scale their businesses and establish strategic synergies with the corporation.

As is known, venture capital investments are inherently risky, with high failure rates among start-ups. A long-term approach allows CVC programmes to balance out early setbacks, continuously validate investment strategies and support portfolio companies throughout their growth cycle. CVC programmes provide access to disruptive technologies, business models and talent pipelines that would be difficult to develop internally within a short timeframe.

Also, the venture capital landscape is dynamic, which means that corporate investors must adapt their strategies to emerging opportunities, which is not something that can be achieved with a short-term strategy.

A long-term vision is not just desirable; it is essential for ensuring that CVC investments drive meaningful innovation, produce strategic growth and have sustained corporate impact.

Definition of the team

The composition of the CVC team is also a determining factor for the success of the operation of CVC programmes. It is not enough just to have experienced professionals; it is essential to balance corporate knowledge with expertise in the venture capital market. This balance allows for a more strategic approach, ensuring that CVC can act effectively in selecting start-ups, managing the portfolio and creating value for the parent company.

Diverse teams not only bring together different perspectives but also improve innovation capacity and decision-making.

Teams that combine professionals from within the corporation and the venture capital ecosystem have significant advantages:

- *Greater buy-in from leadership:* Solo industry teams are more likely to present less alignment with the strategic objectives of the parent company. When the team has representatives from both the company and the innovation market, there is greater acceptance and involvement of the corporation's executives, ensuring strategic support and avoiding misalignment of expectations, as discussed earlier.
- *Improved relationship with start-ups:* CVCs with homogeneous teams tend to face difficulty in integration between start-ups and the corporation. Professionals who understand the corporate culture and the innovation market are able to establish more productive connections, thus increasing collaboration and the implementation of strategic synergies.
- *Operational autonomy:* Diverse teams tend to be more autonomous, enabling agile decisions without relying excessively on corporate bureaucracy.

The structuring of CVC teams must contemplate establishing points of contact within the parent company. It is important to create direct channels with executives and leaders of strategic areas to facilitate the capture of synergies and accelerate innovation processes, while also identifying and reporting any obstacles or problems with a much clear and fast approach.

In summary, the composition of a CVC's team directly influences its ability to generate value and maximise the return on investments. Success depends on a balanced structure, which combines the corporation's internal knowledge with the agility and innovation of the venture capital market.

Focus on value creation

Continued management of the portfolio companies is a key factor in the success of a CVC programme.

The initial investment of a CVC programme in a start-up is only the first step in a complex journey, where value creation is the most critical aspect to ensure impact for both the invested company and the corporation. Active portfolio management and continuous engagement are crucial for CVC to fulfil its role as a catalyst for innovation and strategic growth.

After the capital injection, the CVC needs to intervene actively to ensure that start-ups have the necessary support to thrive. This support involves closely monitoring the start-up's devel-

opment, and evaluating growth metrics, challenges faced and opportunities for integration with the parent company. Corporations must act fast and diligently so that start-up solutions can be applied within the corporation, accelerating innovation and creating competitive advantages.

In addition to capital, start-ups need ongoing support from the corporate investor's business areas in the form of access to networks, mentorship, technology resources and corporate expertise. The CVC should act as a facilitator of this support.

The CVC programme should be much more than just an investor. Smart money can be a reality when the CVC acts as an innovation connector, ensuring that start-ups have a favourable environment in which to grow while also driving the transformation of the parent company. To ensure that the CVC adds value, it is essential that the business areas participate from the beginning of the investment process and on a continuous basis.

During the ongoing evaluation of a start-up, internal departments research how its solutions can be incorporated into the company and can accelerate the growth of the start-up by opening doors to new market opportunities and internal customers. Also, involving the departments responsible for the core business of parent company allows the CVC to enable the implementation of the start-up's innovations in a structured way. As industries shift, CVC teams that are close to the start-up businesses remain agile and can recalibrate their approaches based on new market trends.

Without post-investment engagement, start-ups may struggle to scale, miss integration opportunities or even fail due to lack of support. Successful CVC initiatives integrate start-ups' innovations into the corporation's broader business strategy. When done effectively, start-ups gain a strong corporate partner, while corporations leverage cutting-edge technology or market insights.

When properly explored, active portfolio management serves both ways. Start-ups and corporations often possess distinct expertise. Corporate investors can offer mentorship, operational efficiency insights and market access, while start-ups contribute agility and innovative thinking. This exchange leads to knowledge transfer that benefits both parties.

Other challenges

- *Bureaucracy and decision-making hurdles:* Corporate investment committees often introduce bureaucratic delays, which can be detrimental in a fast-moving start-up ecosystem. CVC investments require agility to seize opportunities before competitors do. Slow approval processes within corporations may result in missed investment prospects, reducing the effectiveness of CVC initiatives.
- *Regulatory challenges:* Brazil's investment and start-up regulatory framework can be quite complex, especially in certain industries such as fintech and healthtech. CVC investors must navigate the legal complexities relating to regulatory, taxation and compliance aspects.

Conclusion

CVC in Brazil is a complex yet promising investment vehicle and a powerful tool for innovation that enables corporations to access disruptive technologies and explore innovation-driven growth. While the potential for strategic growth is immense, its success depends on several factors that should be carefully managed:

- *Strategic alignment:* Effective integration with corporate strategy, overcoming cultural barriers, and balancing financial and strategic objectives. CVC initiatives must be closely tied to corporate goals, ensuring investments contribute to long-term innovation rather than short-term financial gain.
- *Long-term vision:* Unlike traditional investments, venture capital requires patience. Benefits from start-up partnerships and innovation-driven growth materialise gradually.
- *CVC team composition and post-investment engagement:* The success of a CVC depends on a well-structured team that blends corporate experience with venture capital expertise, fostering efficient portfolio management and enhancing value creation.
- *Regulatory and other operational challenges:* Bureaucracy within the corporation's structure, along other regulatory and compliance hurdles in certain sectors, can slow down CVC operations. Corporations need to adopt agile and adaptive frameworks to mitigate these obstacles.

Despite these challenges, companies that skilfully navigate the complexities of CVC can unlock significant value, driving innovation while strengthening their market position. A well-structured, actively managed CVC strategy has the potential to transform corporate innovation and fuel sustainable growth.

CAYMAN ISLANDS

Law and Practice

Contributed by:
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Campbells is a leading full-service offshore law firm established in 1970. From its offices in the Cayman Islands, the British Virgin Islands and Hong Kong, the firm provides comprehensive corporate and litigation advice and services to clients worldwide in relation to Cayman Islands and British Virgin Islands law. Campbells is regularly trusted to advise some of the most prominent names in finance and investment and is frequently involved in the largest and most complex transactions in both jurisdictions. The venture capital team comprises 15 attorneys and is internationally recognised for its expertise by leading directories and trade publications. The firm is actively involved in the development of legislation, sitting on critical government legislative committees. Work highlights include advising Barrick Gold Corporation and its affiliates on its Cayman Islands joint venture arrangement with Shandong Gold Mining Co., Ltd. in respect of the Veladero gold mine in Argentina, and advising Hark Capital on the set-up and launch of its closed-ended Cayman Islands debt fund.

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Campbells

1. Trends

1.1 VC Market

Campbells had a busy 12-month period where it advised on the following:

- QI Tech, a Brazilian fintech, in connection with its initial USD200 million Series B funding and USD50 million Series B extension round, led by General Atlantic, with participation from Across Capital;
- Xapo Bank, a formerly VC-backed virtual asset currency provider, in connection with a management buyout, in a transaction involving capital flows in excess of USD2 billion;
- NG Cash (a Brazilian digital bank targeting younger generations) in its USD12.5 million Series A round, led by Monashees and Andreessen Horowitz;.
- netLex, a Brazilian life cycle management provider in its USD22.7 million funding round, led by Riverwood; and
- Brandlovrs, a Brazilian marketing start-up that uses AI to match companies with creators, in its fundraising of USD6.6 million led by Kaszek.

1.2 Key Trends

The Cayman Islands continues to see significant growth in the venture capital industry, with the number of private funds registered with the Cayman Islands Monetary Authority at an all-time high with the total number of funds registered reaching over 30,000 by the end of 2024.

Notable trends included a rise in venture capital funds investing in cryptocurrencies, blockchain, Web3, and decentralised finance (DeFi) and a continued focus on credit, infrastructure, real estate, private debt, and technology sectors.

In the venture capital equity financing space, 2024 saw more down rounds, convertible note financings, and series round extensions. However, the market is hopeful for an increase in equity rounds in the second half of 2025, with Q1 already showing an increase in activity compared to Q1 2024.

1.3 Key Industries

We have seen the Cayman Islands increasingly become a hub for venture capital investments in the blockchain space. Enhancements to the Cayman Islands Virtual Asset Service Providers Act have encouraged the establishment of funds investing in tokenised assets, NFTs, DAOs, and other blockchain-based projects. Cayman Enterprise City and Tech Cayman initiatives have further strengthened the fintech ecosystem by providing infrastructure and regulatory support. Beyond blockchain and fintech, venture capital activity has also focused on broader technology sectors such as software development, mobile gaming, and AI-driven solutions.

Latin American markets still favour the Cayman Islands for venture capital activity for various reasons, including investor familiarity, liability certainty, tax neutrality and legal certainty. While 2021-2024 saw primarily fintech companies using the Cayman structure, 2024-2025 is starting to see an increase in healthtech and education tech companies seeking funding through the offshore structure. In more recent times, we have seen a trend for some LatAm operating companies with holding structures in the USA to consider continuing out of the USA and into the Cayman Islands, in some cases to mitigate against regulatory risk borne out of the US nexus, in preparation for transactional activity.

Industries with high exit activities included financial services driven by strategic sales and PE-

backed IPOs and technology (reflecting demand for mature software and enterprise tech companies). Industries attracting financing rounds included fintech and blockchain (each receiving early-stage/seed financing). Emerging areas like AI-driven solutions also drew seed funding during 2024.

2. Venture Capital Funds

2.1 Fund Structure

The typical structure for a venture capital fund is the Cayman Islands-exempted limited partnership, which provides flexibility in capital commitments and distributions while offering limited liability protection for limited partners. One or more of the partners is a general partner who has legal responsibility for the operation of the partnership and management of its business, together with unlimited liability for the debts of the partnership. These are invariably Cayman Islands companies or foreign companies registered to do business in the Cayman Islands which have very few assets, to avoid serious financial loss pursuant to the general partner's unlimited liability for the debts of the partnership. The remaining partners are limited partners, who are restricted from participating in the management of the partnership's business, but who have liability for the debts of the partnership limited to the extent of their investment. Various activities may be carried out by limited partners without limited partners becoming liable as general partners by virtue of participating in the management of the partnership. Such funds are regulated under the Cayman Islands Private Funds Act (as revised) (for closed-ended funds).

The main governing document is the limited partnership agreement.

2.2 Fund Economics

Fund principals (initiators, managers, or general partners) can participate in the economics of a venture capital fund through several mechanisms. These are designed to align their financial interests with the fund's performance and incentivise long-term value creation. Typically this will be by way of (i) management fees (ie, an annual fee charged to limited partners (LPs) to cover operational expenses such as salaries, office costs, and travel typically set at 2% of the fund's assets under management (AUM), following the *"2/20 rule"* and (ii) carried interest (*"carry"*) which is a share of the fund's profits earned by general partners after surpassing a predefined hurdle rate (eg, 8%) distributed after portfolio companies exit successfully, typically in later years of the fund's life (seven to ten years). It is generally set at 20% of profits, although this can vary based on fund size and structure.

Fund principals may also invest their own capital alongside LPs in portfolio companies, giving them direct exposure to potential upside.

2023/24 saw the introduction of CIMA's enhanced corporate governance framework requiring funds to adopt risk-based governance structures, including independent directors for oversight, audit committees for larger funds and clear conflict-of-interest policies (much of which has already been adopted by venture-capital funds). The Beneficial Ownership Transparency Act (as revised), effective July 2024, also saw an expansion of scope to exempted limited partnerships (albeit funds registered with CIMA are able to avail themselves of an alternate route to compliance and provide a contact name for the reporting of beneficial ownership at the request of the Competent Authority as opposed to maintaining a beneficial ownership register).

2.3 Fund Regulation

A venture capital fund that is established in the Cayman Islands will usually be regulated as a Cayman Islands private fund in accordance with the Private Funds Act (as revised). A private fund is any company, unit trust or partnership (wherever established) that offers or issues or has issued investment interests, the purpose or effect of which is the pooling of investor funds with the aim of enabling investors to receive profits or gains from such entity's acquisition, holding, management or disposal of investments, where:

- the holders of investment interests do not have day-to-day control over the acquisition, holding, management or disposal of the investments; and
- the investments are managed as a whole by or on behalf of the operator of the private fund, directly or indirectly, but this does not include certain licensed or registered persons or any non-fund arrangements.

The general partner of the fund will typically be a Cayman Islands-exempted company. If the fund is managed by a fund manager, the fund manager may be registered in the Cayman Islands under the Securities Investment Business Act (as revised) or (as is usually the case) can be established elsewhere. No Cayman Islands laws or regulations will apply to a fund manager based in a jurisdiction other than the Cayman Islands.

The SIBA regulates *"securities investment business"*, which includes managing securities, dealing in securities, arranging deals in securities and advising on deals in securities. The SIBA defines the term *"securities"* widely and includes a list of instruments that are common in today's financial markets (shares in the capital of a company, interests in a limited partnership, units of participation in a unit trust, debt instruments, warrants, certificates, options, futures and contracts for differences).

The SIBA designates certain persons as *"Registered Persons"* to whom the full licensing provisions of the SIBA do not apply. Entities that are eligible to become Registered Persons include, in summary, persons providing securities investment business on an intra-group basis, persons providing securities investment business to defined *"high net worth"* and *"sophisticated"* clients and persons regulated by a recognised overseas regulator in an overseas jurisdiction in which such securities investment business is being conducted.

2.4 Particularities

The Cayman Islands' venture capital landscape has evolved significantly over the past year, driven by regulatory innovation, market trends, and investor demand. Below are critical observations across impact funds, fund-of-funds activity, continuation funds, and broader sector dynamics.

Fund-of-Funds Activity

- Growth in Multi-Strategy Funds: Fund-of-funds structures focusing on digital assets, private debt, and equities have proliferated, with Cayman-registered funds increasingly pooling capital for diversified exposure. This aligns with global asset allocation trends favouring alternative investments

Continuation Funds

- GP-Led Secondary Market Growth: Continuation funds are increasingly deployed to extend holding periods for illiquid assets (eg, infrastructure, real estate). These structures allow existing investors to roll over interests or exit, while new capital is raised for follow-on investments.

- Hybrid Financing Models: Continuation funds leverage blended facilities combining uncalled capital commitments and asset portfolios to address concentration risks. This approach is particularly popular for tech and digital asset portfolios.

Impact and ESG Integration

- Emerging ESG Strategies: While explicit government-backed VC funds are not prominent, ESG-aligned funds are gaining traction. Cayman's enhanced governance rules (eg, independent directors, risk frameworks) support impact-focused strategies.

Digital Asset Dominance

- Blockchain and Web3 Leadership: A significant number of Cayman-based fintechs raised capital in 2024, with funds leading investments in DeFi, NFTs, and tokenised assets.

Exit Environment

- IPO Pipeline Revival: Improved market conditions in 2025 are expected to unlock exits for mature VC-backed firms, particularly in fintech and AI.

Fund Strategies for Extended Average Holding Periods

To accommodate extended average holding periods, venture capital and private equity funds employ several strategies that align with long-term investment goals. These strategies focus on maximising returns over longer horizons while managing risks and capital efficiently. One approach involves structuring funds with longer lifespans, providing additional time to realise value from investments. Another strategy is the use of continuation funds, which allow fund managers to extend the holding period of existing assets, enabling further growth and value realisation without the pressure of an immediate exit. Buy-and-hold strategies emphasise holding investments for extended periods to benefit from compounding returns and reduced transaction costs; by avoiding frequent buying and selling, funds minimise the impact of market volatility and timing risks.

3. Investments in Venture Capital Portfolio Companies

3.1 Due Diligence

Due diligence with respect to Cayman Islands entities will typically include a review of:

- basic corporate information, including the memorandum and articles of association, registers of directors and of members, particularly to evaluate the requirement for any third party or shareholder/board consents and any most-favoured-nation provisions in respect of an investor;
- any charges included on the register of mortgages and charges;
- if the entity is in good standing with the Cayman Islands registrar of companies;
- whether compliant with economic substance and beneficial ownership regimes;
- any litigation against the entity; and
- all statutory books and records of the entity.

3.2 Process

The timeline for completing a financing round in a growth-stage company with new anchor investors can vary depending on factors such as the company's maturity, market conditions, and investor readiness. New anchor investors may require additional time for negotiation and due diligence compared to existing investors familiar with the company. Economic uncertain-

ty or competitive fundraising environments can extend timelines.

Below is an analysis of the relationships of the various parties in one round.

Existing v New Investors

- Conflicting Interests: New investors often negotiate preferential terms (eg, liquidation preferences, anti-dilution protections), which can conflict with existing shareholders' rights. Existing investors may resist terms that dilute their ownership or alter governance structures.
- Pro-Rata Rights: Existing investors may exercise pro-rata rights to maintain their ownership percentage in follow-on rounds. If they decline, new investors can fill the gap, leading to shifts in control.
- Valuation Sensitivity: Existing investors may push for *"flat round"* (same valuation as prior rounds) to avoid dilution, while new investors might demand an *"up round"* if the company's value has increased.

Majority Requirements v Unanimous Consent

- Majority Approval:
  (a) Investor Majority: Decisions like equity issuance or corporate actions often require approval from investors holding a majority of shares (eg, 50–75%). This streamlines decision-making but may marginalise minority stakeholders.
  (b) Class-Specific Consent: Protective provisions for preference shareholders (eg, veto rights over exits) may require majority consent within their class.
- Unanimous Consent:
  (a) Such consent is required for amendments affecting distribution rights or economic entitlements in fund agreements. Unanimity is rare due to practicality concerns but may apply to high-stakes changes.
  (b) Founder Safeguards: Founders may negotiate exceptions to prevent minority investors from blocking critical decisions (eg, operational budget approvals).

The above factors ensure balanced governance while protecting stakeholder interests in evolving venture capital landscapes.

3.3 Investment Structure

In the Cayman Islands, venture capital financings often involve instruments beyond common stock equity issuances, particularly in early-stage investments, as outlined below.

Preference Shares

- Features: These shares typically offer dividend rights, liquidation preferences, anti-dilution protections, protective provisions and exit rights (eg, redemption options if an anticipated exit event does not occur within a specified timeframe).
- Investor Protection: Preference shares provide investors with priority over ordinary shareholders in case of liquidation, and in payments of dividends/making of distributions, ensuring a higher level of protection for their investment. Investors also typically either negotiate board representation and/or a schedule of protective provisions (the content/scope of which will vary depending on the proportionate stake being acquired on a post-money basis) to protect against fundamental changes in the company or in the negotiated rights of the investors.

Convertible Notes

- Use in Early-Stage Financing: Convertible notes are common in early-stage investments

as they delay valuation discussions until later rounds.
- Conversion Terms: These notes convert into equity at a predetermined valuation or discount in future financing rounds, offering flexibility for both investors and companies. Some convertible instruments are linked to performance hurdles, or other trigger events, and offer interest capitalisation mechanics and other conversion ratchets, thereby enhancing the prospect of a greater upside for investors, particularly in depressed markets.
- Advantages: They are simpler to execute than equity rounds and provide a quick way to raise capital without immediate valuation disputes.

Redeemable Preference Shares
- Redemption Rights: These shares include provisions allowing investors to redeem their shares if certain conditions are not met (eg, failure to achieve an exit event within a specified timeframe).
- Flexibility: The terms of redemption can be tailored to suit investor needs, providing an exit mechanism if the company does not meet performance milestones.

Warrants
- Additional Equity Options: Warrants grant investors the right to purchase additional shares at a predetermined price, often used alongside other financing instruments.
- Incentivisation: They can incentivise investors by offering potential upside without immediate equity dilution.

SAFEs (Simple Agreements for Future Equity)
- Use in Early-Stage Financing: SAFEs are common in early-stage investments as they delay the issuance of equity until later rounds while still taking the benefit of a cash injection. SAFEs are also typically prepared on standard Y Combinator forms, which makes their use even more attractive particularly for founders seeking to limit negotiation and legal spend in these early stages of growth.
- Conversion Terms: The SAFEs typically convert into equity at a predetermined valuation or at a discount to the price per share in future financing rounds, offering flexibility for both investors and companies.
- Advantages: They are simpler to execute than equity rounds and provide a quick way to raise capital without immediate valuation disputes or dilution for the founders.

3.4 Documentation
A typical financing round in a growth company in the Cayman Islands involves core documents such as a term sheet, subscription agreement, shareholders' agreements, amended M&AA, PPM (if required), board resolutions, legal opinions, and updated statutory registers. The exact documentation may vary depending on the instruments issued (eg, preference shares v convertible notes) and specific investor requirements. These documents ensure clarity in governance, compliance with Cayman law, and protection for all parties involved in the transaction.

Frequently used templates in Cayman Islands financing rounds include NVCA model documents, adapted for use in the context of Cayman targets, which streamline transactions while maintaining compliance with local regulations and global best practices. Key templates include:

- Term Sheet;
- Share Purchase Agreement;
- Investors' Rights Agreement;
- Voting Agreement;

- Right of First Refusal and Co-Sale Agreement;
- Management Rights Letters; and
- Director Indemnification Agreements.

3.5 Investor Safeguards

Venture capital (VC) investors in the Cayman Islands typically secure critical rights to protect their investments in downside scenarios, such as company liquidation. These terms prioritise their financial recovery over other stakeholders like ordinary shareholders, founders, and employees. Below are the key terms and their implications.

Liquidation Preferences

- Priority in Asset Distribution: Preference shareholders (including VC investors) are typically entitled to receive a return of their investment (often 1x–2x the principal) before ordinary shareholders in a winding-up scenario. This is a standard feature of preference shares under Cayman law.
  (a) Ranking Order: After secured creditors (eg, banks) are paid, preference shareholders rank above unsecured creditors and ordinary shareholders, including employees and founders holding equity.

Redemption Rights

- Exit Mechanism: Investors can demand redemption of their shares if the company fails to achieve an exit (eg, IPO or sale) within a specified timeframe (typically two to five years).
  (a) Enforcement: If the company cannot pay, investors may issue a statutory demand and petition the court for liquidation (unless they have agreed to fund on a non-petition basis, which is rare). Failure to comply may provide grounds for a petitioner to approach the court for a just and equitable winding-up.*"Legally Available Funds"* Defence: Companies may contest redemption claims by arguing insufficient *"legally available funds"*, but courts interpret this narrowly (excluding funds needed for ordinary operations).

Contractual Safeguards

- Automatic Conversion Triggers: Preference shares may convert to ordinary shares upon the occurrence of pre-determined event (eg, a qualified IPO) or, alternatively, upon a liquidation event, if redemption is infeasible, ensuring investors retain residual claims after creditors.

Governance Controls

- Veto Rights: Investors often secure veto rights over major decisions (eg, asset sales, debt issuance, amendments to governing documents or authorised share capital, issuances of security ranking pari passu or senior to the last issued preference share class) to prevent actions that could harm their position pre-liquidation.
- Liquidation Petitions: Investors can initiate *"just and equitable"* winding-up petitions if mismanagement or deadlock jeopardises their interests, though this requires court approval.

Anti-Dilution Protections

- Down-Round Adjustments: Full-ratchet or broad-based weighted-average anti-dilution clauses protect investors' ownership percentages in subsequent down rounds, indirectly safeguarding their liquidation payouts.

Anti-dilution protections are widely used in Cayman Islands VC financings, particularly for preferred shareholders, as they safeguard investors

against both percentage and economic dilution in subsequent funding rounds.

The forms are as follows:

- Full Ratchet:
  (a) adjusts the conversion price of preferred shares to match the price per share of the new issuance, regardless of the amount raised; and
  (b) is most favourable to investors but less common due to its impact on founders and other shareholders.
- Broad Based Weighted Average:
  (a) adjusts the conversion price based on a formula that considers the number of new shares issued and their price relative to previous rounds; and
  (b) balances investor protection with fairness to existing shareholders and is the more commonly adopted mechanism.

These provisions are typically included in the company's memorandum and articles of association (M&AA), ensuring enforceability in future rounds.

Pre-Emption/Subscription Rights

Prevalence: Pre-emption rights are frequently incorporated into financing agreements to allow existing shareholders (including VC investors) to subscribe for new shares before they are offered to external parties.

The forms are as follows:

- Mandatory Pre-emption Rights: Existing shareholders are entitled to subscribe for new shares proportionate to their current holdings. This right is often stipulated in investors' rights agreement.
- Negotiated Pre-emption Rights: Investors may negotiate broader pre-emption rights, allowing them to acquire additional shares beyond their proportional entitlement during new issuances.

Such rights protect against percentage dilution by enabling investors to maintain their ownership stakes and ensure alignment between existing shareholders and incoming investors during equity raises.

Neither anti-dilution nor pre-emption rights are statutory under Cayman Islands law. Instead, they must be expressly agreed upon in governing documents (eg, M&AA, subscription agreements or the shareholders agreements).

Recent shifts in market conditions have led to more favourable terms for investors in venture capital and private equity financings in the Cayman Islands, particularly in light of economic uncertainty and increased competition for capital. These terms are designed to enhance investor protections and returns, especially in downside scenarios. Below are the key developments.

Participating Liquidation Preferences

- Participating liquidation preferences have become more common, allowing investors to *"double dip"* by receiving their initial investment (liquidation preference) and participating pro-rata in the remaining proceeds alongside common shareholders.
- Some agreements include capped participation, limiting the additional returns investors can receive beyond their liquidation preference to balance fairness among stakeholders.

Compounding Preferred Returns

- Preferred returns that compound annually have gained traction, particularly in funds with

longer holding periods or higher risk profiles (eg, growth-stage companies or distressed assets).
- This ensures that limited partners (LPs) receive a guaranteed return on their capital before general partners (GPs) earn carried interest, providing an incentive for strong fund performance.

Pay-to-Play Provisions
- These provisions require existing investors to participate in follow-on financing rounds to avoid losing certain rights, such as anti-dilution protections or liquidation preferences.
- In recapitalisation transactions or down rounds, pay-to-play provisions have been increasingly employed to encourage investor participation and ensure adequate funding.

Enhanced Redemption Rights
- Investors are negotiating stronger redemption rights, allowing them to redeem their shares if an anticipated exit (eg, IPO or trade sale) does not occur within a specified timeframe (typically two to five years).

Stricter Anti-Dilution Protections
- While weighted-average anti-dilution remains standard, full-ratchet adjustments have become more prevalent in down rounds or distressed financings, ensuring investors maintain their economic position regardless of new issuance prices.

3.6 Corporate Governance
Investors in Cayman Islands ventures typically secure significant influence over management and corporate governance through a combination of contractual rights, share class structures, and regulatory frameworks. Below are the key mechanisms and market-standard rights.

Governance Influence
- Board Representation:
  (a) Depending on the size of their investment as a proportion of the post-money valuation, investors often negotiate seats on the board of directors, or observer seats, particularly in growth-stage companies. This ensures direct oversight of strategic decisions and operational management.
  (b) Independent Directors: Cayman funds increasingly appoint independent directors to balance governance, mitigate conflicts of interest, and align with CIMA's corporate governance guidelines.
- Veto Rights:
  (a) Investors secure veto power over critical decisions, such as:
    (i) major asset sales or mergers;
    (ii) issuance of new equity or debt; and
    (iii) changes to the company's constitutional documents.
  (b) These rights are typically embedded in shareholders' agreements (where they relate to key business decisions – eg, adoptions of or amendments to business plans) or the company's articles of association (where they relate to key structural items – eg, creations of equity incentive plans, issuances of new securities ranking pari passu or senior to the last-issued preference share class).

Information Rights
- Investors require regular access to financial statements, operational updates, and material disclosures to monitor performance and compliance (often subject to confidentiality and trade secret carve-outs).

Market Standard Rights
- Liquidation Preferences: Preferred shareholders (eg, VC investors) have priority in asset

distribution during winding-up, often receiving 1x–2x their investment before ordinary shareholders.
- Anti-Dilution Protections: Weighted-average or full-ratchet anti-dilution clauses adjust conversion prices in subsequent down rounds to protect investors' ownership stakes.
- Redemption Rights: Investors may demand redemption of shares if exit events (eg, IPO) do not occur within two to five years. Failure to redeem can trigger winding-up proceedings.
- Pre-emption Rights: Existing investors maintain the right to participate in new equity issuances to avoid dilution, often codified in the company's constitutional documents.
- Constitutional Document Provisions: The memorandum and articles of association (M&AA) define shareholder rights, voting thresholds, and reserved matters requiring investor consent (eg, mergers, material borrowings).
- Shareholders' Agreements: These contracts formalise governance roles, exit mechanisms (eg, drag-along/tag-along rights), and dispute-resolution processes.

CIMA's 2023 updates mandate robust governance frameworks, including conflict-of-interest policies, risk management systems, and transparency in decision-making. Operators (eg, boards) must act in the fund's best interests, enhancing investor protections.

3.7 Contractual Protection

In venture capital and private equity financings in the Cayman Islands, representations, warranties, covenants, and undertakings are tailored to mitigate risks and ensure compliance with local laws. Below is a summary of market-standard terms and recourse mechanisms for breaches.

Representations and Warranties

Common Representations by a Cayman target as well as a VC investor, in the context of a VC financing:

- Corporate Authority:
  - (a) valid existence, good standing, and authority to execute agreements, including under Cayman law;
  - (b) confirmation that constitutional documents permit financings and security grants;
  - (c) up-to-date capitalisation and disclosures as to potential dilution;
  - (d) details of subsidiaries;
  - (e) absence of third-party consents and related-party transactions; and
  - (f) validity of shares to be issued in connection with financing.
- Financial and Operational Integrity:
  - (a) accuracy of financial statements and absence of undisclosed liabilities; and
  - (b) ownership of material assets, including intellectual property.
- Legal Compliance:
  - (a) compliance with applicable regulatory regimes (eg, Private Funds Act, AML/KYC, economic substance, beneficial ownership, data protection); and
  - (b) no ongoing litigation or regulatory investigations.
- Security Validity:
  - (a) enforceability of security interests over assets (eg, capital call rights, shares).

Investor Representations

- Accredited investor status, investment experience and compliance with AML/KYC requirements.

Covenants and Undertakings

Affirmative covenants

- Regulatory Maintenance:
  - (a) registration with CIMA under the Private Funds Act (for funds) and ongoing compliance; and
  - (b) regular financial reporting and notification of material adverse changes.
- Operational Commitments:
  - (a) use of funds for agreed purposes (eg, growth initiatives); and
  - (b) preservation of corporate structure and key assets.

Negative covenants

- Restrictions on Debt/Encumbrances:
  - (a) limits on additional borrowing or security grants without investor consent.
- Exit Timelines:
  - (a) commitment to pursue exits (eg, IPO, sale) within stipulated periods (typically two to five years).

Recourse for Breaches

Contractual remedies

- Indemnification: Investors may claim damages for losses caused by breaches of warranties (eg, misrepresentation in financials).
- Cure Periods: Ventures are allowed to rectify breaches (eg, late regulatory filings) within 15–30 days before defaults are triggered.
- Acceleration/Redemption Rights:
  - (a) Lenders may demand immediate repayment or enforce security (eg, capital call rights).
  - (b) Investors may redeem preference shares if exit timelines are missed.

Enforcement actions

- Liquidation Petitions: Investors can petition courts for winding-up if ventures are insolvent or breach material obligations.
- Tort Claims: For intentional misrepresentation or conspiracy, investors may pursue direct claims against founders/management.

Security enforcement

- Capital Call Rights: Lenders enforce security over uncalled capital via equitable assignments, requiring notice to investors under Dearle v Hall principles.
- Asset Realisation: Security over shares, bank accounts, or intellectual property can be liquidated to recover debts.

4. Government Inducements

4.1 Subsidy Programmes

The Cayman Islands government and quasi-government entities have introduced several initiatives to support equity financing in growth companies, particularly in technology, innovation, and financial services. While direct equity investment programmes are limited, the jurisdiction's regulatory framework and strategic economic policies create an attractive environment for venture capital and private equity activity.

Cayman Enterprise City (CEC) is a quasi-government special economic zone (SEZ) designed to attract global tech companies, start-ups, and innovation-driven businesses. Key incentives include:

- Tax Benefits: exemptions from corporate tax, capital gains tax, and import duties;
- Streamlined Set-up: fast-tracked business licensing and work permits for investors and employees; and
- Networking and Mentorship: access to a community of 250+ global companies, fostering collaboration and investment opportunities.

4.2 Tax Treatment

The Cayman Islands have no direct taxes of any kind. There are no corporation, capital gains, income, profits or withholding taxes. There are no inheritance taxes or death duties. Upon application to the government, Cayman companies, limited partnerships, trusts and SPCs can expect to obtain a written undertaking that they will be exempted from taxes for a minimum of 20 years (companies and SPCs) and 50 years (limited partnerships and trusts). Accordingly, any income or capital gains (whether accumulated or distributed) will not be subject to tax in Cayman. However, this may be taxable in the home jurisdiction of investors and any manager. The Cayman Islands does not have any double taxation treaties, and there are no exchange control or currency restrictions in the Cayman Islands. The Cayman Islands do not have any double taxation treaties.

4.3 Government Endorsement

Please see **4.1 Subsidy Programmes**.

5. Employment Incentives

5.1 General

To secure the long-term commitment of founders and key employees, ventures in the Cayman Islands utilise a combination of equity-based incentives, contractual obligations, and governance mechanisms. These approaches align the interests of key stakeholders with the company's growth objectives while ensuring retention and performance.

Equity or Quasi-Equity Based Incentives

Employee stock option plans (ESOPs)

- Purpose: ESOPs are widely used to incentivise and retain key employees by granting them the right to purchase shares at a predetermined price after meeting certain conditions (eg, vesting periods).
- Key Features:
  (a) Option Pool: A percentage of equity is reserved for employees, typically 10–20% of the company's total shares.
  (b) Vesting Schedules: Standard vesting terms include a four-year schedule with a one-year cliff, ensuring employees remain committed for an extended period before fully benefiting from their options.
  (c) Tax Efficiency: The Cayman Islands' tax-neutral regime ensures no local taxes on stock option grants or exercises, though employees may face tax liabilities in their home jurisdictions.

Restricted stock units (RSUs) or restricted ordinary share grants

- RSUs are occasionally used for senior management, granting shares outright after meeting performance or time-based milestones. Typically, such units are subject to transfer restrictions and include conditions allowing for repurchase by the company, which are activated in a scenario where the employee leaves.

Share appreciation rights or phantom stock units

- There are contractual entitlements to cash sums equivalent to the then fair market of an underlying security in the company, usually subject to vesting schedules.

Co-Investment Opportunities

Employee co-investment schemes

- Key employees are offered opportunities to invest alongside institutional investors in the company or fund, aligning their financial interests with long-term success. This approach

fosters a sense of ownership and accountability while enhancing employee retention.

Employment agreements with restrictive covenants

- Non-compete clauses prohibit founders and key employees from engaging in competing businesses for a specified period after leaving the company.
- Non-solicitation clauses prevent former employees from poaching clients or staff post-departure.
- Employment contracts may tie bonuses or equity vesting to achieving specific business goals, ensuring alignment with company performance.

Founder lock-up agreements/share restriction agreements

- Founders often enter into lock-up agreements restricting the sale or transfer of their shares for a defined period (eg, three to five years). This ensures stability during critical growth phases and reassures investors of the founders' long-term commitment.
- Founders may alternatively enter into a share restriction agreement whereby their shares are subject to a right of first refusal in favour of the company should the founder leave within a certain time period before shares have vested.

Governance Mechanisms to Retain Control

- Founders may negotiate provisions to retain control over strategic decisions despite equity dilution:
  (a) Founder Director Rights: These rights ensure founders maintain board representation, giving them influence over major decisions.
  (b) Super-Voting Shares: Founders may hold shares with enhanced voting rights (eg, ten votes per share) to preserve control while raising external capital.

5.2 Securities

Please see **5.1 General**.

5.3 Taxation of Instruments

Please see **4.2 Tax Treatment**.

5.4 Implementation

The implementation of an investment round and the set-up of an employee incentive programme (eg, stock option pools) are closely linked processes, with overlapping impacts on company ownership and dilution. Below is a breakdown of their relationship.

Process Interrelation

Investment round triggers ESOP creation/expansion

- Pre-Money Option Pools: Investors often require companies to establish or expand employee stock option pools (ESOPs) before finalising the investment. This ensures sufficient equity is reserved for future hires, with dilution borne by existing shareholders (founders/early employees) rather than new investors.
- Post-Money Option Pools: These are less common, as investors prefer pre-money structures to avoid dilution of their own shares.

Valuation and equity allocation

- The ESOP size (typically 10–20% of fully diluted shares) is negotiated during the investment round. Larger pools may be mandated for growth-stage companies planning aggressive hiring.

Legal documentation
- ESOP terms (eg, vesting schedules, exercise prices) are formalised in a documented plan approved by the board and shareholders, with shares reserved for issuance thereunder during the investment round.
- Employees will enter into separate share option agreements/awards with the company.

Post-Funding Hiring
- Post-investment, the ESOP is used to grant equity to new hires, aligning their incentives with the company's growth trajectory.

Dilution dynamics

Dual Dilution sources
- Investment Round: Issuing new shares to investors reduces all existing shareholders' ownership proportionally.
- ESOP Creation: Reserving shares for employees further dilutes existing shareholders.

Cumulative impact
- Early employees face double dilution: from new investor shares and subsequent ESOP expansions.

Valuation v dilution trade-off
- While dilution reduces ownership percentages, a higher post-money valuation can increase the absolute value of equity.

In terms of anti-dilution protections, investors may secure weighted-average anti-dilution rights, but employees rarely receive similar protections. Alternative structures include the use of phantom equity or RSUs to incentivise employees without immediate share issuance. In terms of the vesting schedule, it is recommended to implement four-year vesting with a one-year cliff to ensure employee retention aligns with company milestones.

6. Exits

6.1 Investor Exit Rights

In the Cayman Islands, shareholders' rights during liquidity events such as trade sales or IPOs are typically governed by a combination of contractual provisions and corporate law. Below are the key exit-related provisions that regulate shareholders' interactions.

Drag-Along Rights
- These provisions allow a majority shareholder (often investors) to force minority shareholders to sell their shares to a buyer on the same terms as the majority.

Tag-Along Rights
- Minority shareholders have the right to join a sale initiated by majority shareholders, ensuring they are not left behind. This protects minority shareholders by allowing them to participate in exit opportunities on equal terms. Such rights are often paired with drag-along rights to balance majority and minority interests.

Pre-Emption Rights
- Existing shareholders have the right to purchase new shares before they are offered to external parties, maintaining their ownership percentage. This prevents dilution and ensures existing shareholders can participate in future equity issuances. While not directly related to exits, pre-emption rights can influence ownership structures leading up to an IPO or trade sale.

Lock-Up Agreements
- Such agreements prohibit shareholders from selling their shares for a specified period post-IPO to maintain market stability. This encourages long-term investment

and prevents immediate post-IPO sell-offs. Such agreements are typically required by underwriters in IPOs to ensure orderly market conditions.

Redemption Rights

- Investors may have the right to redeem their shares if an exit event (eg, IPO, trade sale) does not occur within a specified timeframe (eg, two to five years). This provides an exit mechanism for investors if anticipated liquidity events are delayed or fail to materialise. Failure to redeem can lead to winding-up proceedings, as investors may petition the court to liquidate the company.

Exit-Related Governance Provisions

- Investors often secure board seats to influence strategic decisions, including exit timing and terms. Investors may also have veto power over major decisions, such as asset sales or mergers, to protect their interests leading up to an exit.

In addition to tag-along and drag-along rights, transfer restrictions include a right of first refusal whereby investors often hold a contractual right to purchase shares before they are offered to third parties. This ensures continuity and allows current stakeholders to retain ownership influence. A company's memorandum and articles of association may restrict transfers unless approved by the board or shareholders. Transferors must also adhere to procedures outlined in shareholders' agreements (eg, offering shares to existing investors first).

Exit mechanisms are typically defined in constitutional documents and financing agreements to align investor and company interests as outlined below.

Time-based exit events

- Redemption Rights: Investors may demand share redemption if an IPO or trade sale does not occur within a predefined period (eg, two to five years).
- Conversion Rights: Preferred shares often convert to ordinary shares upon IPO, enabling participation in public market liquidity.

Performance triggers

- Liquidation Preferences: In a sale or winding-up, investors receive priority payouts (1x–2x capital) before ordinary shareholders.
- Missed Milestones: Failure to meet revenue, valuation, or operational targets may trigger forced exits or investor redemption rights.

Enforcement of exit rights

- If a company cannot fulfill redemption obligations (eg, insufficient funds), investors may issue a statutory demand and petition for court-supervised liquidation. Winding-up petitions are advertised, allowing other creditors/shareholders to intervene, complicating control for the petitioning investor.

The scarcity of conventional exits has driven Cayman Islands investors to prioritise contractual redemption rights, NAV financing, and liquidation safeguards. Legal enforcement (eg, winding-up petitions) and innovative fund structures (eg, evergreen vehicles) now dominate market practice, reflecting a shift toward flexibility and preemptive risk mitigation in prolonged illiquid environments.

6.2 IPO Exits

After a slowdown in 2022–2023 due to high interest rates and geopolitical uncertainty, 2024–2025 projections suggest a rebound in the IPO market, driven by easing regulations and inves-

tor confidence. Tech, fintech, and blockchain start-ups dominate IPO pipelines.

The IPO process for Cayman entities typically takes 6–18 months, influenced by factors such as market conditions, regulatory alignment, and corporate preparedness.

Cayman entities are frequently used as listing vehicles for IPOs on major exchanges (eg, NYSE, NASDAQ, Hong Kong). The Cayman Islands Stock Exchange (CSX) is less common for start-ups, as most target larger international markets.

6.3 Pre-IPO Liquidity

The rarity of immediate IPOs has created a tangible market need for secondary market trading in the Cayman Islands. Mechanisms such as tender offers, private auctions, company buybacks, and trust structures are frequently used to provide liquidity for early investors, employees, and founders while maintaining control over ownership structures. These programmes are particularly relevant for companies at later funding stages or those experiencing delays in traditional exit events.

Existing memorandum and articles of association often impose pre-emption rights, board approval requirements, or outright transfer prohibitions, necessitating amendments to enable structured liquidity. Private company shares also lack transparent pricing mechanisms, leading to disputes over fair value. It is also necessary to balance founder/employee liquidity needs with investor protections (eg, anti-dilution rights, liquidation preferences).

Company-facilitated tender offers are a valuable tool for providing liquidity to employees and early investors while maintaining control over ownership structures. They serve as an interim solution when traditional exits like IPOs or trade sales are delayed, addressing stakeholder needs without compromising long-term strategic goals. However, careful planning around pricing, governance approvals, regulatory compliance, and funding sources is essential to ensure successful implementation.

7. Regulation

7.1 Securities Offerings

A Cayman Islands venture capital fund will be regulated as a private fund with the Cayman Islands Monetary Authority in accordance with the Private Funds Act. Exemptions for *"proprietary money"* (eg, employee investments) apply only if participation is strictly limited to direct employees. Offering documents or marketing materials must contain prescribed language.

It is not commonplace to offer a venture capital fund's shares/interests to the general public in the Cayman Islands and typically most investors/employees will be based outside of the Cayman Islands and therefore subject to the laws of those jurisdictions.

Shares/interests may be offered to Cayman Islands-exempted companies and exempted limited partnerships, but certain types of promotional activity in the Cayman Islands will require regulatory oversight. Legal advice should be sought in each case.

Structuring for multiple stakeholders may include the establishment of a segregated portfolio company, which allows compartmentalisation of assets/liabilities across investor groups. This is ideal for multi-strategy funds or employ-

ee co-investment tranches and employee co-investment vehicles.

Venture capital portfolio companies will not offer shares to the public unless participating in an IPO (in which case the relevant listing rules and obligations will apply). Shares may not be offered to the general public in the Cayman Islands.

7.2 Restrictions

The Cayman Islands does not have a general foreign direct investment regime and there are no restrictions on foreign ownership of land or real estate in the Islands.

Specific rules apply to foreign ownership and control of local businesses. The Local Companies (Control) Act (as revised) typically requires that 60% of the ownership interests in the local business be held/controlled by Caymanians. Furthermore it will be necessary to apply for a trade and business licence.

Such restrictions do not apply to Cayman Islands-based entities that conduct business exterior to the Cayman Islands.

Investments into locally licensed and regulated businesses are subject to approval by the Cayman Islands Monetary Authority, including ensuring that any such persons are fit and proper to make such investment.

There are currently no foreign exchange controls or foreign exchange regulations.

Recent updates to the Beneficial Ownership Transparency Act broadly mean that certain individuals or entities who own or control (directly or indirectly) 25% or more of the issued share capital in a Cayman Islands entity, exercise ultimate effective control over the management of such entity or exercise control through other means will need to provide certain information for inclusion in that company's beneficial ownership register. The information can include personal information such as full name, birth date and nationalities, but does not become publicly available (save that access may be granted to members of the public, who can evidence a "legitimate interest" to access beneficial ownership information for a specific legal person where evidence is provided that the specific legal person is linked to money laundering or terrorist financing).

In certain circumstances, where one or more ultimate beneficial owners cannot be identified, the company may elect to record a senior managing official (ie, a director) as the beneficial owner or take another alternative route to compliance to the extent available.

The economic substance regime also provides that, where Cayman Islands companies are conducting certain relevant activities, they must annually report their relevant income generated by that activity and satisfy an *"economic substance test"*, proving that they have adequate physical presence within the Islands. Investment funds are excluded from the economic substance regime.

Trends and Developments

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Campbells

Campbells is a leading full-service offshore law firm established in 1970. From its offices in the Cayman Islands, the British Virgin Islands and Hong Kong, the firm provides comprehensive corporate and litigation advice and services to clients worldwide in relation to Cayman Islands and British Virgin Islands law. Campbells is regularly trusted to advise some of the most prominent names in finance and investment and is frequently involved in the largest and most complex transactions in both jurisdictions. The venture capital team comprises 15 attorneys and is internationally recognised for its expertise by leading directories and trade publications. The firm is actively involved in the development of legislation, sitting on critical government legislative committees. Work highlights include advising Barrick Gold Corporation and its affiliates on its Cayman Islands joint venture arrangement with Shandong Gold Mining Co., Ltd. in respect of the Veladero gold mine in Argentina, and advising Hark Capital on the set-up and launch of its closed-ended Cayman Islands debt fund.

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The Cayman Islands maintained its dominance as a global epicentre for venture capital (VC) and private equity activity in 2024, leveraging its tax-neutral regime, adaptive regulatory framework, and innovative fund structures. With 17,292 private funds registered under the Private Funds Act by the end of the final quarter of 2024 and a 4.8% year-over-year growth in closed-end vehicles, the jurisdiction solidified its position as the preferred offshore hub for cross-border VC strategies. This article examines the ecosystem's evolution through regulatory reforms, sectoral shifts, and structural innovations, while addressing persistent challenges and emerging opportunities.

Regulatory Landscape: Balancing Transparency and Flexibility

CIMA regulatory measures

New rules and guidance formed part of a series of changes introduced by the Cayman Islands Monetary Authority (CIMA) in late 2023, designed to modernise its approach and ensure that various rules and statements of guidance are applied consistently across the various regulated sectors.

The Rule – Corporate Governance for Regulated Entities, and the Rule and Statement of Guidance – Internal Controls for Regulated Entities, both become effective in October 2023. These measures, which outline the regulator's minimum expectations, followed CIMA's previous updates, including guidance on governance, outsourcing, cybersecurity and record retention.

Looking into the detail of the framework for corporate governance and internal controls, the regime previously in place for mutual funds was extended to private funds, in addition to certain new provisions. All regulated funds are required to implement and maintain a framework for corporate governance and internal controls. CIMA states that this framework must be proportionate to the size, complexity, nature of business and the risk appetite of the regulated entity.

Operators of regulated funds in the Cayman Islands, as the governing body, have ultimate responsibility for compliance and should be fully aware of their obligations. In addition to the company directors, managers of an LLC and the trustee of a unit trust, operators now include general partners of private funds established as partnerships.

In many cases, regulated private funds will already be broadly in compliance with these measures, given the strong culture of corporate governance that exists in the Cayman Islands. Where a regulated entity believes any rules are not applicable, based on the proportionate approach outlined above, it is the responsibility of the entity to demonstrate to CIMA why that is the case, if required.

The guidance confirmed that service providers or group-wide functions for internal controls or corporate governance frameworks can be relied upon to meet obligations; however, funds may be required to demonstrate the effectiveness of these arrangements. Operators of a regulated fund are also responsible for requesting appropriate information from any service providers or advisers, to be satisfied the fund is operating in compliance with all laws and regulations.

In addition to the prescribed duties of operators and extensive obligations regarding conflicts of interests, the CIMA guidance provides a useful reminder of the minimum expected requirements for board meetings. Operators of a regulated fund should meet at least once a year, although this should be more frequent if

the size, complexity, structure, nature of business or risk profile of the fund demands so. As part of the governing body's oversight function, service providers should also be requested to attend meetings where necessary.

Beneficial Ownership Transparency Act (BOTA) reforms and key obligations for CIMA-registered funds

The Beneficial Ownership Transparency Act (BOTA), effective 31 July 2024, expanded the scope of the Cayman Islands beneficial ownership regime. It introduced new compliance requirements for entities, including those previously exempt. Registered mutual funds and private funds are impacted but benefit from an alternative compliance route.

Alternative compliance route

CIMA-registered mutual funds and private funds are not required to report their Registrable Beneficial Owners (RBOs). Instead, they must provide their Corporate Service Provider (CSP) with details of a designated Contact Person. This alternative route simplifies compliance while ensuring access to beneficial ownership information when required.

Contact person requirements

- Only entities licensed or registered with CIMA or fund administrators holding a Mutual Fund Administrators Licence under the Mutual Funds Act can serve as a Contact Person.
- The Contact Person acts as a liaison between the fund and competent authorities, ensuring timely access to beneficial ownership information within 24 hours upon request.

Written confirmation obligations

For compliance under BOTA:

- CIMA-registered funds must submit written confirmation to their CSP detailing the Contact Person's information.
- If any information in the confirmation becomes inaccurate, funds must update their CSP within 30 days to amend and file corrected details with the competent authority.

Maintaining updated information

Funds must ensure that any changes related to the Contact Person or other compliance details are promptly communicated to their CSP. Failure to do so may result in penalties or administrative fines.

Penalties for non-compliance

Registered funds failing to comply with BOTA requirements may face:

- administrative fines starting at KYD5,000 per breach, increasing by KYD1,000 monthly until capped at KYD25,000; and
- potential dissolution if fines remain unpaid for 90 days.

Timing and transitional period

While BOTA took effect on 31 July 2024, enforcement of new requirements began in January 2025.

This streamlined approach under BOTA ensures that CIMA-registered mutual funds and private funds meet international transparency standards while minimising administrative burdens through an alternative compliance pathway. Registered funds can also opt in to maintain a beneficial ownership register if preferred.

Fund Formation and Structural Innovations

Dominance of exempted limited partnerships (ELPs)

ELPs continue to be a favoured investment vehicle, due to their pass-through tax treatment ensuring profits, losses, and capital gains flow directly to investors without Cayman Islands taxation. This aligns with onshore tax frameworks (eg, US partnerships), making them attractive for cross-border investments.

ELPs are governed by the Exempted Limited Partnership Act (as revised) which allows partners to customise terms (eg, capital commitments, profit distribution, governance) via the Limited Partnership Agreement. No separate legal personality simplifies contractual arrangements, with the general partner holding assets on trust for the partnership.

From a liability protection perspective, the general partners assume liability for debts and management and limited partners liability is capped at their investment unless they participate in management.

Structural advantages in the venture capital space include no withholding taxes, capital gains taxes, or corporate taxes in the Cayman Islands and the securing of a 50-year tax undertaking from the Cayman government, ensuring future tax immunity.

ELPs therefore balance investor protections, operational agility, and tax efficiency. Their dominance reflects decades of refinement in catering to global private capital markets.

Rise of niche fund strategies

Investor demand for specialised mandates drove growth in:

- A number of new Cayman funds incorporated environmental, social, and governance criteria, focusing on climate tech start-ups developing carbon capture solutions, and social impact ventures targeting financial inclusion in emerging markets.
- Continuation Funds: Secondary transactions grew year-on-year, enabling general partners to extend fund lifecycles amid stagnant IPO markets.
- Venture Debt Vehicles: NAV-based lending facilities continued to grow, providing liquidity to late-stage start-ups like AI-driven fintech platforms.

Cross-border structuring trends

Jurisdictional synergies emerged as a key theme:

- North American Investors: A number of US-sponsored ELPs utilised Cayman-Delaware "mirror" partnerships to allow funds to cater to both domestic and international investors and to bypass state-level regulatory redundancies. Such structures allow funds to streamline operations, avoid duplicative regulatory burdens, and potentially optimize tax efficiency.
- Japanese Institutional Allocations: Japanese institutional investors continue to show a growing interest in alternative investments, and Yen-denominated ELPs secured USD2.8 billion in commitments despite currency volatility, focusing on robotics and semiconductor ventures. Investments in these areas also reflect broader global trends, such as the rise of AI and high-performance computing, which drive demand for cutting-edge semiconductor solutions.
- Middle Eastern Sovereign Partnerships: Shorooq Partners, a MENA-focused VC firm backed by sovereign wealth funds, utilised a Cayman structure to invest in early-stage tech

start-ups. Cayman-based funds like Blockchain Capital and Multicoin Capital attracted SWF capital for digital asset ventures.

Sectoral Investment Focus

Technology: adjusted valuations drive opportunistic deployments

Post-2023 valuation resets enabled Cayman funds to acquire stakes in:

- Generative AI Platforms: USD1.3 billion was deployed across 14 Series B+ rounds, led by Tiger Global and Sequoia China.
- Blockchain Infrastructure: Coming out of the crypto winter, USD900 million flowed into decentralized finance (DeFi) protocols. The rise of digital asset funds reflects the growing integration of blockchain technology in fund operations and investments. These funds target blockchain-based projects and tokenised assets, offering opportunities for innovation and efficiency in the digital economy.

Sustainable infrastructure: bridging the emerging markets gap

Infrastructure investments remain a significant focus for private funds in the Cayman Islands. Venture capital firms are leveraging opportunities in real estate and infrastructure development, particularly in emerging markets or regions undergoing modernisation.

Challenges in the 2024 Ecosystem

Exit market constraints

The venture capital industry faced significant exit market constraints in 2024. These challenges stemmed from macroeconomic pressures, regulatory hurdles, and structural market shifts.

The 2024 exit environment saw the lowest activity in a decade, with the end of quarter 3 recording just USD10.4 billion in total exit value and only 14 public listings. While full-year exit value reached USD149.2 billion, this was driven by small, early-stage exits (70% from companies that had raised no further than Series A). Cayman-based funds, which often hold mature, high-value start-ups, faced disproportionate challenges due to the scarcity of large exits.

Key constraints included:

- Ageing Unicorns: 40% of unicorns in VC portfolios were held for 9+ years, creating a backlog of illiquid assets.
- Concentration in Small Exits: 90% of exits involved Series B or earlier companies, generating minimal returns for later-stage investors.

The global IPO market is expected to rebound in 2025, providing liquidity events for VC-backed companies.

Strategic Opportunities for 2025

A promising economic outlook and improved fundraising conditions have led to a resurgence in venture capital activity.

Digital asset fund innovation

The Cayman Islands has emerged as a leading jurisdiction for digital asset venture capital (VC) funds in 2025, leveraging its innovative legal frameworks and tax-neutral environment to attract blockchain-focused investments, in particular tokenised VC fund structures where investor interests are represented by blockchain-based tokens, with smart contracts automating capital calls and distributions.

2025 has already seen increased VC activity in:

- blockchain infrastructure projects (Layer 2 solutions, ZK-proof systems);

- tokenised real-world assets (RWAs) using Cayman SPVs; and
- AI-powered DeFi protocols.

The jurisdiction's ability to accommodate smart contract audits, on-chain KYC solutions, and DAO governance structures positions it as the offshore hub for next-generation venture investing.

AI

Global VC trends in 2025 show a surge in investments in AI-driven start-ups, particularly in areas like generative AI, machine learning, and automation. The jurisdiction's flexible regulatory framework allows funds to adapt their strategies to emerging technologies, making it an attractive base for tech-focused investments.

Emerging market convergence

Alternative investments in emerging markets such as Latin America, Africa, and Southeast Asia are attracting significant interest. Cayman-based funds can leverage their expertise in structuring complex cross-border deals to tap into these high-growth regions.

Hybrid fund models that blend traditional and digital asset strategies are becoming increasingly popular. These structures allow funds to diversify risk while tapping into both conventional markets and emerging digital economies.

Subscription finance lines (capital call facilities) and hybrid facilities combining NAV loans are also gaining traction as funds seek larger financing options.

Concluding Remarks

The Cayman Islands' proactive adoption of FATF protocols in the beneficial ownership and VASP travel rule space (amongst others) will enable the jurisdiction to sustain its offshore primacy through the next market cycle.

With predictions of tech company numbers doubling by 2027 and continued institutional interest in alternative investments, the Cayman Islands is well-positioned to capitalise on these trends. The jurisdiction's commitment to fostering innovation while maintaining its reputation as *"gold standard"* offshore centre ensures it will remain a magnet for venture capital activity.

In summary, the Cayman Islands combines its status as a top-ranked financial hub with cutting-edge innovation in technology and finance. These factors make it an unparalleled destination for venture capital funds looking to thrive in 2025's dynamic global market.

CHILE

Law and Practice

Contributed by:
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Barreda Legal Tech is an innovative Chilean law firm specialising in the intersection of law and technology. With a strong focus on digital transformation, the firm advises companies on technology regulation, venture capital deals, data protection, cybersecurity, intellectual property, and regulatory compliance. Their team combines legal expertise with advanced knowledge in technology and business, allowing them to provide agile and efficient legal solutions. They use technological tools in legal services, optimising processes and delivering data-driven strategic advice. The firm's commitment to innovation and excellence positions it as a leading legal tech firm in Chile. Barreda Legal integrates law and technology to offer cutting-edge solutions to the challenges of the digital world. Their clients include Kushki, Fraccional, Soyio, Getxerpa, Minga Ventures, and Alea Ventures.

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1. Trends

1.1 VC Market

In 2024, approximately USD514.7 million was invested across 95 funding rounds, with an average ticket size of USD1.7 million per start-up. This information was provided by the Chilean Venture Capital Association (ACVC) to the media in Chile (as of the date of this writing, the 2025 Impact Report, which covers the funding rounds from 2024, has not been published).

Among the main funding rounds of 2024 were:

- over USD20 million: Botanical Solution, Topsort, and Wild Foods;
- over USD10 million: PhageLab; and
- over USD5 million: Fintoc, Toku, Colektia, Kilimo, and AgroUrbana.

1.2 Key Trends

Due to the lack of liquidity in the market, investment rounds are taking longer to close, and there is increased competition among start-ups for funding. As a result, valuation caps in investment contracts (typically SAFEs) have decreased, which benefits investors in the event of a future equity conversion. At the same time, investors are seeking more solid and well-justified valuations, leading to more thorough and lengthier financial and legal due diligence processes. Finally, given the heightened competition among start-ups, investors are now able to secure governance clauses – even in early-stage deals – that grant them some influence over the start-up's day-to-day operations.

1.3 Key Industries

The industries that attracted the most capital in funding rounds were greentech and cleantech, accounting for 43% of the total. They were followed by fintech and insurtech companies with 15%, and agtech and foodtech with 11%. These figures were provided by the ACVC (Chilean Venture Capital Association).

2. Venture Capital Funds

2.1 Fund Structure

They are typically structured through private investment funds managed by an administrator registered with the Financial Market Commission (CMF). Currently, there are corporate venture capital funds, family offices, and conventional VC funds. Some of these funds are composed entirely of private equity, while others combine equity with debt obtained through a CORFO credit line (ranging from USD6.7 million to USD89 million). It is also common to form a joint stock company (SpA) to pool capital, which is then invested in start-ups. In parallel, a separate SpA is often created to manage the fund and bring together the general partners and the VC team.

2.2 Fund Economics

In general, fund principals participate in the fund's economics by first charging a management fee, which typically ranges from 1% to 2.5% of the capital managed throughout the duration of the fund. On the other hand, they share in the fund's success by receiving a carried interest, which is generally around 20%. Finally, it is common and preferred for the general partner(s) to also be contributors to the fund (due to tax limitations, they usually hold no more than 20% of the fund's capital as contributors).

2.3 Fund Regulation

There is no specific regulation for venture capital funds. Both private and public funds are generally regulated by the Single Fund Law (No 20,712). However, there are certain specific ben-

efits aimed at financing private funds, such as CORFO's credit lines.

2.4 Particularities

VC funds in Chile are supported by CORFO through financing lines that follow an equity/debt ratio of 2:1, 1:1, and 0.5. In general, the funds allocate a portion of the money for supporting start-ups in future rounds, and the goal is to gradually liquidate investments in the different rounds. Exits are not as common as in other markets.

3. Investments in Venture Capital Portfolio Companies

3.1 Due Diligence

In general, due diligence processes are more or less intensive depending on the stage the respective start-up is in. The main areas of focus are valuation, financial evaluation, market, founding team, technology used, clients, and governance.

As for legal due diligence, it typically includes reviewing the corporate structure, key contracts with clients, employment matters of employees and founders, tax compliance, litigation, and potentially regulatory issues affecting the company (eg, financial service providers regulated by the CMF).

3.2 Process

The round duration generally depends on the number of investors and the stage the company is in. In early-stage investments, multiple investors usually conduct their own due diligence, which, even if simple, takes time and can distract the founders significantly. This process typically lasts between two to five months. In later stages, there is generally a lead investor who manages the due diligence process along with other VCs. Although more information is available at this stage, it is typically better organised, so the round generally takes between three to four months.

3.3 Investment Structure

In Chile, the most common financing instrument at the early stage is the SAFE (Simple Agreement for Future Equity), whose model from YC is generally adapted to Chilean regulation. This facilitates the set-up of structures abroad (mainly Delaware and the Cayman Islands) in preparation for more advanced rounds, through the FLIP. These agreements allow investors to receive shares in a future funding round (a valuation cap is established, and potentially a discount) and generally do not specify an expiration date or interest associated with them.

Next, we have the convertible loan, which is a debt instrument (a money credit transaction) that can convert into equity in future rounds, containing a valuation cap and potentially a discount. This instrument is subject to the stamp tax, with the amount depending on various factors (amount, term, etc). To a lesser extent, capital increases with the issuance of ordinary or preferred shares are used. These instruments generally set rules for information and governance, preferential rights in liquidation, anti-dilution provisions, MFN (most favoured nation), etc.

3.4 Documentation

In Chile, a start-up financing round in the growth stage typically involves the following key documents:

- Term Sheet: A preliminary document that outlines the basic terms and conditions of the investment. While non-binding in most of its

clauses, it sets the foundation for subsequent negotiations.
- Capital Increase with Issuance of Paid Shares: This is an agreement where investors agree to contribute capital in exchange for shares in the company. Additionally, it may be agreed in parallel to purchase a certain number of shares from the founders, providing them with some liquidity.
- Shareholders' Agreement: This is a crucial document that regulates the relationships between shareholders, including economic and political rights, drag-along and tag-along clauses, restrictions on share transfers, preemptive rights, and more.
- Statutory Modifications: These are legal documents that reflect the formal approval of the transaction by the company and any amendments to the by-laws agreed upon with the investor (typically, a new board of directors and governance structure is established).
- Supplementary Agreements: Depending on the case, these may include vesting contracts for founders (typically reverse vesting), stock option plans for employees, non-compete and confidentiality agreements, or specific clauses related to corporate control.

In Chile, there is no set of standardised, mandatory documents; however, it is common for ecosystem participants – particularly VC funds and incubators/accelerators – to refer to certain clauses from international models, especially those from the NVCA (National Venture Capital Association) in the United States, adapting them to Chilean legislation.

3.5 Investor Safeguards

- Downside Scenario: In recent years, due to the current market conditions, clauses have been strengthened to protect investors during critical periods of the company, especially during liquidation. It is common for VC investors to have preferential rights to the proceeds in case of liquidation. Generally, these clauses allow them to recover their investment first (and in some cases, a multiple of it) before distributing the remaining proceeds among the founders and other shareholders. However, it is important to note that not all preference clauses have value. In a formal liquidation process under Law No 20.720 (the Law on Business and Personal Reorganization and Liquidation), the legal priority of credits applies, and creditors have precedence over shareholders in the distribution of the company's assets.
- Anti-dilution Clauses: SAFEs, commonly used in the early stages, usually do not include anti-dilution clauses because they are designed to be simple, quick, and favourable to start-ups at early stages. The original model from Y Combinator (widely used in Chile and adapted to our legislation) does not include anti-dilution clauses. *"Weighted average"* or *"full ratchet"* (to a lesser extent) are used in more advanced and growth-stage rounds. The most common mechanism is the *"weighted average"*, which adjusts the conversion price of preferred shares in the event of a future round at a lower valuation.
- Pre-emption Rights: These are standard clauses in almost all shareholders' agreements. They grant investors the right to participate proportionally in future funding rounds, allowing them to maintain their ownership percentage and avoid dilution. Like anti-dilution clauses, these are more commonly used in later-stage rounds and are rarely included in SAFEs.
- Additional Common Rights: In situations of greater uncertainty, clauses such as veto rights over key decisions, greater participation in the board of directors, and *"pay-to-*

play" clauses, which require investors to participate in future rounds if they wish to retain certain privileges (such as preferential rights or anti-dilution), have also been strengthened. However, these clauses are also used in more advanced rounds and are rarely included in SAFE agreements.

3.6 Corporate Governance

Early-stage investors generally are not involved in the management of the company. However, in more advanced stages (Seed-Series A and beyond), while investors typically do not engage in the day-to-day operations of the start-ups, they do seek to ensure a significant level of control and influence over the company's strategic and structural decisions through contractual clauses and corporate governance structures. Some of the most common rights that are negotiated include:

- Board Member Appointment: This allows investors to have direct visibility into management, access relevant information, and participate in key decisions. In some cases, it is agreed that certain decisions can only be approved with the favourable vote of the director appointed by the fund (veto right).
- Veto Rights on Strategic Matters: Through the shareholders' agreement (sometimes incorporated into the company's by-laws), investors often establish that certain matters require their prior consent, such as capital increases, sale of significant assets (in Chile, a shareholders' meeting is also required to approve sales representing more than 50% of the company's assets), debt exceeding certain amounts, changes to the corporate purpose or structure, issuance of new shares or convertible securities, amendments to the by-laws, among others.
- Access to Information: Investors usually include clauses granting them the right to receive periodic (monthly, quarterly, annual) updates on the financial, operational, and commercial status of the company. This is commonly included from early stages. It is also common to find clauses that grant the investor the right to audit or review financial statements and accounting records. Once they hold a seat on the board, the investor gains permanent access to such information.

3.7 Contractual Protection

Early Stage

Generally, in SAFE agreements (commonly used in early-stage investments), the investor makes general representations such as having the legal capacity, understanding the investment's purpose, and acknowledging the risks involved.

The start-up typically declares that it is duly incorporated, in good standing, and in compliance with the laws of its jurisdiction, and that it has the necessary legal capacity to enter into and execute the SAFE agreement. It affirms that the instrument has been validly authorised by its competent corporate bodies and does not contravene any relevant laws, contracts, or active authorisations. The start-up also declares that executing the contract does not create conflicts or adversely affect its assets, operations, or essential licences. Finally, the company states that it possesses the necessary intellectual property rights for the development of its business, without infringing third-party rights.

Later Stages (especially Series A and beyond)

Typically, in capital increases, subscription agreements (post-capital increase), and/or shareholders' agreements, the following conditions are included:

Representations and warranties
The most common include:

- The company is validly incorporated and operates in accordance with the law.
- The financial statements reasonably reflect the company's financial situation.
- There are no hidden liabilities or ongoing material litigation.
- The intellectual property used belongs to the company and does not infringe third-party rights.
- There are no prior agreements that may affect the investment or the investor's rights.
- The founders usually also declare that they have acted in good faith and disclosed all relevant information (the *"full disclosure"* clause).

Covenants and undertakings (future commitments and obligations)
- not to incur debt above a certain threshold without board approval;
- not to amend the bylaws without investor consent;
- not to distribute dividends without prior approval;
- to promptly inform investors of relevant events; and
- the obligation to dedicate full time to the business or not compete with the company for a specified period, etc (in the case of *"founders' covenants"*).

Remedies
In the event of breaches or false representations/warranties, the investor may seek various remedies, which are typically specified in the contracts:

- the right to seek damages, with or without limits (eg, caps on liability or limited warranty periods);
- the right to repurchase shares at face value or with a discount if the breach is serious;
- the right to remove a founder from the board or management (in cases of misuse of funds, fraud, etc);
- clauses accelerating certain obligations or preferential rights; and
- in some cases, escrow agreements or retention of part of the committed capital as a guarantee against potential contingencies.

On the other hand, start-ups typically negotiate liability limitations, minimum thresholds for claims, and limited prescription periods (eg, 12 or 18 months).

Finally, it is very relevant to review the interpretation of such clauses from a judicial perspective in Chile to have an effective understanding of the scope and viability of each one.

4. Government Inducements

4.1 Subsidy Programmes
One of CORFO's financing lines is the FC line, designed for funds that invest in the development and growth of start-ups. This differs from the FE and FET lines, which are granted to funds investing in early-stage companies. A fund that obtains an FC line must focus on investing in start-ups that have a validated product or service with sales.

4.2 Tax Treatment
General Taxation Applicable to All Companies
Start-ups, like any other company in Chile (including those of investors), are subject to the general first category tax (corporate tax) on their

profits. Shareholders/investors (individuals) are taxed with final taxes (global complementary or additional tax) when they receive withdrawals or distributions of profits.

Profits obtained from the sale of start-up shares will be subject to taxes, although in some cases, they may qualify for exemptions or benefits established in the Income Tax Law, depending on the specific case.

Taxation Applicable to Investment Funds

Investors participating through regulated vehicles such as public or private investment funds can benefit from a more efficient tax treatment. The Single Fund Law (LUF) establishes that funds do not pay taxes on their capital gains, but taxes are incurred at the contributor level, which allows for deferral of taxation until the actual withdrawal of profits.

4.3 Government Endorsement

In Chile, recent governments have developed various initiatives to promote financing through capital in early-stage and growth-stage ventures, with a special focus on start-ups and innovative companies. The main public institution responsible for these policies is CORFO (*Corporación de Fomento de la Producción*), which has played a key role in the development of the venture capital ecosystem.

Some of the most relevant initiatives include:

- Financing Programmes for Investment Funds: CORFO has launched financing lines where it co-invests with an investment fund, not as a contributor but as a creditor of the fund through a credit line.
- Contributions to Start-Ups: Through instruments such as Start-Up Chile and Capital Semilla, among others, CORFO provides money to support entrepreneurs in the early stages, facilitating their subsequent access to investment rounds.
- Capital Markets Strengthening Initiatives: CORFO and Start-Up Chile have also collaborated on the development of platforms such as ScaleX (Santiago Venture Exchange), an alternative market on the Santiago Stock Exchange designed for start-ups and scale-ups to raise capital more efficiently.

These public policies have been crucial in building the venture capital ecosystem in Chile, attracting both national and international investors, and promoting a culture more open to risk investment.

5. Employment Incentives

5.1 General

In Chile, venture capital investors typically secure the commitment of founders and key employees through vesting clauses (reverse vesting for those who are already shareholders), which allow shares or economic rights to be acquired or consolidated gradually over time. These clauses are complemented by transfer restrictions, buyback rights (under certain conditions, the price per share is penalised), and non-compete agreements, all aimed at aligning the incentives of the founding team with the sustainable development of the business.

5.2 Securities

The most commonly used instrument to incentivise founders and key employees is primarily the stock option agreement in its various forms (depending on whether it is vesting for founders or stock options for employees).

A typical vesting period of four years with a one-year cliff is usually established, during which the beneficiary gradually acquires rights over the shares. Reverse vesting is also used, especially for founders, where the company has the right to repurchase shares in the event of early departure.

These instruments are usually tied to the beneficiary staying with the company, and the shares can be fully or partially lost if the employment or business relationship ends. It is important to note that the reason for the departure is relevant in these cases, and it could determine the forfeiture of the shares in the event of early departure.

5.3 Taxation of Instruments

From the worker's perspective, generally, the stock option and vesting do not trigger taxation. In the case of exercising the option, if there is an increase in value (between the market value of the shares at the time of exercise and the price paid by the worker), the worker may or may not be taxed, depending on whether they have an individual or collective employment contract that addresses this right to stock options. If the benefit is established in the employment contract, taxation will only occur when the worker sells their shares (if there is a higher value), and not when they exercise the option. Otherwise, they will be taxed both when they exercise the option and upon the future sale of the shares (if there is a higher value in either case). It is important that these instruments are addressed from both a tax and labour perspective.

5.4 Implementation

Investors in venture capital rounds typically request that the employee incentive plan be defined by the time the investment is closed. This ensures clear visibility of the fully diluted share capital and helps avoid future surprises regarding ownership stakes. The option pool generally ranges between 5-10%. The dilution resulting from the incentive plan can be absorbed by the founders or by both the founders and investors. Typically, it is the founders who propose the option pool, and the discussion usually focuses not on the need for the option pool itself, but on who will bear the dilution resulting from it.

6. Exits

6.1 Investor Exit Rights

In Chile, the provisions that establish investors' rights in the event of an exit or liquidity event are typically included in shareholder agreements. These mainly include preemptive rights, tag-along, drag-along, and liquidation preferences. These rules ensure that investors can exit their investment in events such as a trade sale, an initial public offering (IPO), or any other liquidity event. Tag-along rights allow minority investors to participate in the sale if the majority shareholder sells, while drag-along rights compel minority shareholders to sell if the majority shareholder decides to sell. Liquidation preferences ensure that existing shareholders have the right of first refusal to acquire shares from other shareholders who wish to sell.

Additionally, since exits are uncommon in Chile, investors often create funds with longer durations and set longer conversion conditions (eg, in a SAFE). Future investment rounds typically allow investors to sell all or part of their shares to other funds, even when a sale or IPO does not occur. These practices provide greater flexibility for investors in an environment with few liquidity events.

6.2 IPO Exits

In Chile, IPOs are relatively rare as an exit strategy for start-ups. The path to an IPO is often a longer-term goal rather than an immediate option for early-stage ventures, particularly in the start-up and venture capital sectors.

However, ScaleX (from the Santiago Stock Exchange) allows public offerings that are exempt from the requirement of registration with the Commission for the Financial Market (CMF) of the issuer or securities, in accordance with General Rule No 452. The purpose of this is to facilitate the trading of securities from companies in the expansion stage. This has allowed some start-ups (very few so far) to explore this path, which was previously outright dismissed.

6.3 Pre-IPO Liquidity

In the Chilean ecosystem, it is still in its early stages but is starting to emerge. These are secondary or structured transactions that allow certain shareholders to sell their stakes in a high-growth start-up before it goes public. Some Chilean start-ups that are expanding internationally (for example, through Delaware structures) may gain access to funds offering secondary liquidity windows. These transactions are generally used to reward early-stage investors, founders, and key team members without having to wait for a full exit. They allow for a cap table reorganisation, facilitating the entry of new investors and retention of talent by providing partial liquidity while maintaining long-term incentives. Common forms include:

- private secondary sales to new investors (such as late-stage funds or family offices);
- buybacks by the company itself, funded through large investment rounds (typically Series C and beyond); and
- structured tender offers, where a lead fund allows some existing shareholders to partially liquidate their stake.

7. Regulation

7.1 Securities Offerings

The Securities Market Law (Law No 18.045) distinguishes between public offerings and private offerings of securities. Venture capital investments are typically structured as private offerings, which do not require registration with the CMF's Securities Register, as long as certain conditions are met (eg, being directed to a limited number of investors without mass advertising). In larger transactions, care must be taken not to exceed the thresholds that would trigger a public offering. On the other hand, the Fintech Law opens the possibility for creating alternative transaction systems that could allow a secondary market for shares, subject to certain restrictions.

The Corporate Law (Law No 18.046) addresses closed joint stock companies, a legal structure that is less common for Chilean start-ups (the most widely used is the SpA), allowing partners to freely agree on terms through shareholder agreements. However, the issuance of new shares must meet certain legal and statutory requirements, including extraordinary meetings and respecting the preemptive rights of existing shareholders unless expressly waived. SpAs (created by Law No 20.190), on the other hand, provide greater flexibility for these and other types of transactions. In any case, the supplementary rule for SpAs will be the regulations concerning S.A.

7.2 Restrictions

There are no significant restrictions preventing a foreign VC investor from investing in a local growth-stage company or withdrawing their profits, but there are some regulatory considerations to keep in mind:

- Foreign investors can invest freely in Chile under the foreign investment regime established by Decree Law No 600 (now repealed but still applicable to older investments) or, currently, under the Foreign Investment Statute contained in Law No 20.848.
- Investments do not require prior authorisation, except in strategic or regulated sectors (eg, defence, telecommunications, energy).
- Chile does not impose exchange controls. Foreign currencies can be brought into and withdrawn from the country freely, as long as they comply with Central Bank regulations. The same applies to the profits or earnings generated by these investments. It is important to review the tax implications this may have. Additionally, foreign investors can trade currencies in the formal foreign exchange market.
- There are some specific restrictions in regulated sectors (such as banking, media, defence, or fishing), but these usually do not affect typical VC investments.
- The foreign investor must meet certain tax and legal identification requirements in Chile (eg, having an ID, appointing a legal representative with an address in the country).
- Finally, if the investor channels their investments through entities subject to the UAF (eg, banks, stockbrokers, AGFs, etc), the Chilean entity must apply KYC procedures and report suspicious transactions if applicable.

Trends and Developments

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Barreda Legal Tech Barreda Legal is an innovative Chilean law firm specialising in the intersection of law and technology. With a strong focus on digital transformation, the firm advise companies on technology regulation, venture capital deals, data protection, cybersecurity, intellectual property, and regulatory compliance. Their team combines legal expertise with advanced knowledge in technology and business, allowing them to provide agile and efficient legal solutions. They use of technological tools in legal services, optimising processes and delivering data-driven strategic advice. Our commitment to innovation and excellence positions us as a leading legal tech firm in Chile. Barreda Legal integrates law and technology to offer cutting-edge solutions to the challenges of the digital world. Some of their clients include: Kushki, Fraccional, Soyio, Getxerpa, Minga Ventures, Alea Ventures.

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The Role of CORFO in Chile's Venture Capital Ecosystem

In recent years, Chile's venture capital (VC) ecosystem has experienced sustained growth, driven by initiatives from both the private sector and the government. One of the key players in this development is the Chilean Economic Development Agency (CORFO), a state agency that has played a central role in supporting entrepreneurship and innovation. This article explores how CORFO has influenced the VC ecosystem and how its policies have been crucial in encouraging investment in startups and early- and growth-stage companies.

CORFO and Its Mission in the Entrepreneurial Ecosystem

As a public entity, CORFO's mission is to promote the country's economic development through innovation, entrepreneurship, and private investment. Within this context, it provides resources to startups to help them validate ideas, scale, and even fund research and development (R&D) activities needed to create and commercially validate prototypes.

In the VC sphere, the agency has been a key driver in creating programs that promote investment in new businesses, particularly in high-impact and technology-based sectors. CORFO works to reduce Chilean startups' funding gap, especially in their early stages, where private investment is often limited. Through its funding programs for VC funds that invest in startups, CORFO facilitates access to capital for entrepreneurs who would otherwise struggle to attract investors.

CORFO's Investment Funds and Programs

CORFO offers three main programs that provide credit lines to investment funds focused on early- and growth-stage companies, including some of those outlined below

- FET Program (Early-Stage Technology): CORFO provides loans of up to 300% of the private capital committed to the fund, with a financing cap of USD13.5 million. Fund investments must target early-stage technology companies with growth and innovation potential and with annual sales of no more than USD350,000.
- FT Program (Early-Stage): CORFO provides loans of up to 200% of the private capital committed to the fund, with a financing cap of USD 15.8 million. Investments must be in early-stage companies with growth and innovation potential and annual sales of no more than USD3.5 million.

FC Program (Development and Growth): CORFO provides loans of up to 100% of the private capital committed to the fund, with a financing cap of USD24.8 million. Investments must be made in growth-stage companies with high potential and no more than USD23 million in annual sales.

These funds have been crucial in stimulating investment flows into Chilean startups and have fostered the creation of new VC funds in the country.

According to CORFO's latest Public Report on Venture Capital (from 1998 to December 2023), the agency's contributions to these financing programs include:

- USD1.069 billion in credit lines granted to investment funds;
- 72 investment funds with approved credit lines;
- 475 portfolio companies receiving investment; and

- USD878 million invested in startups through the funds.

CORFO as a Facilitator of Collaborative Networks

Beyond funding, CORFO has played a key role in building collaborative networks among entrepreneurs, investors, and companies in Chile. In 2010, it launched Start-Up Chile, a public accelerator for both local and foreign startups at various maturity stages. This is a clear example of how CORFO has facilitated an interconnected ecosystem that benefits both startups and VC funds. Through its acceleration programs, CORFO provides funding and connects startups with mentors, industry experts, and potential investors (eg, through demo days), increasing the long-term success prospects of supported startups.

Start-Up Chile's reported impact includes generating over USD2 billion in sales over a decade. The program has built a community with a portfolio of more than 2,000 startups and entrepreneurs from over 85 countries.

CORFO has collaborated with other initiatives, such as ScaleX (Santiago Stock Exchange). This initiative resulted from a partnership between the Santiago Stock Exchange and CORFO through Start-Up Chile, aiming to create a platform where startups can access funding. ScaleX allows select companies to make public offerings (subject to specific requirements) exempt from registration with the Financial Market Commission (CMF). It facilitates the trading of securities from high-impact, growth-stage companies, broadens local and international funding sources (including qualified investors) and helps position Chile as an investment hub. However, evaluating the initiative's results is still early, as only six startups have participated so far.

Challenges and Opportunities for CORFO Moving Forward

Despite CORFO's success in the VC ecosystem, several challenges remain.

Access to capital at later stages

While CORFO has successfully stimulated early-stage investment, attracting private capital for growth-stage startups remains difficult, limiting long-term scalability. As a result, many startups relocate their parent companies abroad (typically Delaware, the Cayman Islands, or *"sandwich"* structures) to raise growth capital (Series A and beyond) thus in order to avoid this and enable Chilean companies to attract foreign capital directly within Chile, specific tax incentives for foreign funds investing in Chilean startups should be established. Several international models could serve as references.

This restructuring abroad is often done through *"FLIP,"* in which the Chilean company becomes a subsidiary of a foreign parent. CORFO, aware of this practice, has allowed funds it finances to invest in such foreign entities, provided the money is later transferred to the Chilean subsidiary. Instead of enforcing such limitations, CORFO should focus on attracting more foreign investors to make advanced-stage investments through Chile. To do this, Chile must offer tax benefits that make such investments more attractive.

Additionally, given the limited size of the domestic market, it is natural for Chilean companies to seek market expansion. Everyone – CORFO included – should aim to facilitate international expansion while ensuring that the parent company remains in Chile. To achieve this, CORFO, as an ecosystem coordinator, could promote a regulatory agenda that includes tax incentives for foreign VC funds investing in Chile.

Secondary market

Exits are still rare in Chile, so investors typically realize returns only in later-stage funding rounds (Series A and beyond), which are also uncommon. To provide liquidity to early investors and founders, CORFO could lead the development of a secondary market platform (unlike ScaleX, which involves public offerings). Such a platform would enable the easy transfer of equity stakes or convertible instruments (eg, SAFEs), creating a more dynamic VC market overall. To complete the virtuous investment cycle, CORFO should not only encourage startup investment (which it has done well so far) but also ensure investors can eventually realize returns through a more liquid secondary market.

Conclusion

CORFO's role in Chile's venture capital ecosystem has been instrumental in building a solid foundation of support for startups. From direct funding to startups, credit lines to VC funds, and the creation of extensive collaboration networks, CORFO has positioned itself as a key player in driving sector growth. As the ecosystem matures, CORFO's policies must evolve to address new challenges and maximize opportunities for Chilean entrepreneurs. CORFO's continued support will undoubtedly remain a competitive advantage for Chilean startups and investors betting on Chile's entrepreneurial future.

CHINA

Law and Practice

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Zhong Lun Law Firm was established in 1993, and is a pioneering partnership law firm in China. Through decades of strategic growth and unwavering commitment to excellence, the firm has emerged as a pre-eminent full-service law firm. With nearly 400 equity partners and a robust team of over 2,200 professionals, Zhong Lun represents the pinnacle of legal expertise and institutional capability. As one of the first Chinese law firms to specialise in private equity, Zhong Lun has developed unparalleled insights and deep-rooted expertise in this complex domain. Its practice comprehensively addresses the entire life cycle of private fund operations. By combining meticulous legal acumen with strategic foresight, the firm has consistently positioned itself as a leading legal service provider in China's dynamic private equity landscape. Its sustained excellence has been internationally recognised, with Chambers Global repeatedly ranking Zhong Lun in Band 1 for Private Equity – a testament to the firm's exceptional performance and industry leadership.

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1. Trends

1.1 VC Market

TJ Bio's Strategic Restructuring and USD70 Million Series C1 Equity Financing

On 7 February 2024, I-Mab (NASDAQ: IMAB) announced a strategic transformation to become a US-based biotechnology company through a complex divestment of its Chinese operations. The company executed definitive agreements with TJ Biopharma (Hangzhou) Co, Ltd (*"TJ Bio"*), an unconsolidated affiliate, and a consortium of China-based investors.

Key transaction details included the following:

- total equity investment – USD70 million in TJ Bio;
- asset transfer – 100% of I-Mab Biopharma Co, Ltd (*"I-Mab Shanghai"*)
- consideration – up to USD80 million (renminbi equivalent); and
- additional component – extinguishment of approximately USD183 million in existing repurchase obligations.

The transaction represented one of the most sophisticated and intricate deals in the 2024 Chinese biotech sector. Its complexity was marked by multiple challenging legal dimensions, including:

- negotiations with state-owned new investors;
- comprehensive asset spin-off strategy;
- delicate management of existing investors' redemption rights; and
- intricate cross-border corporate restructuring.

The strategic move underscores I-Mab's deliberate repositioning in the global biotechnology landscape, demonstrating advanced corporate strategic planning and complex legal manoeuvring.

Curon's USD1.3 Billion Asset Sale to Merck

Curon Biopharmaceutical, incubated in 2017 by three major financial investors (6D, Boyu and Temasek) with a total USD150 million investment, recently completed a significant asset sale to Merck valued at USD1.3 billion (including a USD700 million upfront payment). The transaction centered on CN201, a promising B-cell depletion therapy asset developed during their seven-year investment period.

Despite strong backing from these prestigious investors, Curon faced challenges in raising Series B funding in the difficult biotech market. Rather than pursuing traditional exit routes such as initial public offering (IPO), the investors strategically pivoted towards an asset sale approach. This culminated in the successful Merck transaction, which represented an optimal exit opportunity for the financial investors.

The Merck deal not only validated the value of CN201 but also demonstrated how patient capital and strategic flexibility in exit planning can create significant returns in biotech investments. This transaction stands out as a prime example of successful value creation in the biotech sector, where development timelines often extend beyond typical venture capital horizons.

1.2 Key Trends

Market Dynamics and Contraction

2022–2023 slowdown: comprehensive market recalibration

The post-COVID-19 pandemic economic landscape witnessed a fundamental restructuring, characterised by extensive market adjustments and intensified regulatory oversight across sectors. As global economic uncertainties prevailed, investor confidence wavered, leading to a marked decline in both transaction volumes and investment values across primary market segments.

Sectoral impact was particularly evident in the technology sphere, where deal momentum decreased substantially, while the consumer goods sector experienced similar investment contractions. This broader market correction manifested in diminished year-on-year performance metrics, both in terms of transaction frequency and total invested capital, as investors adopted more rigorous risk assessment frameworks and demonstrated heightened caution in their investment approaches.

2024 continuing trends: persistent market challenges

The investment environment remained constrained, with transaction volumes continuing to show restraint amidst increasingly robust compliance frameworks that moderated capital flows.

Escalating geopolitical tensions significantly impacted cross-border investment activities, contributing to a sharp decline in foreign investment participation. This period also witnessed enhanced government oversight of domestic investment strategies, fundamentally altering established market dynamics.

Redemption Rights in Chinese Private Equity/Venture Capital (PE/VC) Transactions: a Deep Dive

Prevalence and structural uniqueness

The Chinese PE/VC landscape exhibits distinctive characteristics in its approach to redemption rights, with over 90% of transactions incorporating these provisions. Notably, approximately two thirds of these arrangements extend to include joint and personal founder liability, functioning essentially as *"put option"* a framework that fundamentally diverges from traditional investment protection mechanisms observed in US or EU markets.

The structural architecture of these rights places significant responsibility on founders, who bear personal liability for investment repayment. Redemption triggers are typically anchored to specific performance metrics, including failure to achieve IPO objectives, missed valuation targets, or shortfalls in predetermined financial benchmarks.

Founder vulnerability: systemic risks

The implications of these structures manifest in profound legal and financial consequences, with over 90% of redemption right cases encompassing both corporate and individual founder liability. The potential ramifications extend beyond mere financial penalties, to include:

- comprehensive asset seizures;
- nationwide travel restrictions;
- inclusion in national credit blacklists; and
- effective prohibition from future entrepreneurial pursuits.

This vulnerability is further amplified by China's unique legal framework, characterised by the absence of personal bankruptcy laws and debt discharge mechanisms, resulting in perpetual personal liability for investment shortfalls.

Supreme Court judge interpretation: redemption right exercise parameters, December 2025

The judicial framework has established clear parameters for redemption right exercise, implementing a mandatory six-month window for activation and providing explicit timeframes for triggering repurchase obligations. This interpretation, although *"unofficial"*, classifies redemption rights as a hybrid construct, combining *"formation right"* during the initial six-month trigger period with *"claim right"* subject to a subsequent three-year statute of limitations. While maintaining contractual flexibility for parties to negotiate specific timeframes, courts retain authority to invalidate excessively prolonged terms, emphasising the need for explicit and unambiguous contractual language.

This interpretation has sparked considerable debate. Supporters maintain that it helps stabilise the company by eliminating uncertainty through *"use it or lose it"* approach to repurchase rights. However, critics argue that this interpretation may backfire, as investors – fearing the loss of their protective rights – might hastily exercise their repurchase options, ultimately compromising the company's operational health.

Market and strategic implications

The evolving landscape has prompted sophisticated adaptation strategies among both investors and founders. Contractual frameworks now demand explicit redemption timeline specifications, detailed trigger date definitions, comprehensive procedural documentation and precise notification protocols. Investors have responded with enhanced due diligence processes, accelerated exit strategy development and more robust litigation preparedness measures.

Broader economic and innovation ecosystem impact

The market is experiencing structural transformation as funding models increasingly mirror debt financing structures, potentially suppressing entrepreneurial risk-taking and elevating barriers to entry for innovative start-ups. Government policy signals suggest potential *"tolerance policies"* and ongoing regulatory recalibration, reflecting efforts to balance investor protection with innovation support.

Concluding perspective

The redemption rights framework in China's PE/VC ecosystem represents a sophisticated risk management mechanism that reflects the market's unique developmental trajectory. This system demands unprecedented contractual precision, strategic agility and comprehensive risk assessment capabilities, while highlighting the intricate balance between investor protection and entrepreneurial freedom.

The future trajectory of China's investment ecosystem will largely depend on successfully navigating the delicate equilibrium between safeguarding investor interests and fostering a vibrant, innovative entrepreneurial landscape. This balance becomes increasingly critical as the market continues to evolve and mature within its distinctive regulatory and cultural context.

1.3 Key Industries

Technology and Telecommunications (TMT)

The TMT sector has demonstrated remarkable resilience and strategic significance, particularly in semiconductors, AI and fintech, where investment activity exhibited substantial momentum. This growth trajectory was carefully modulated by regulatory oversight that struck a balance between fostering technological innovation and implementing robust data security protocols, most notably through China's Data Security Law.

The investment landscape evolved to incorporate enhanced due diligence mechanisms and comprehensive cybersecurity evaluations, reflecting the sector's increasing sophistication and regulatory compliance requirements. Strategic technological domains garnered particular attention, underscoring the sector's pivotal role in national development priorities and global competitiveness initiatives.

Life Sciences and Biotech: Declined Pathway

The life sciences and biotech sector has undergone a significant recalibration, departing markedly from previous optimistic market projections. This downturn emerges from an intricate interplay of factors, including persistent macroeconomic headwinds, increasingly complex regulatory frameworks, escalating geopolitical tensions and inherent structural market constraints.

This sectoral contraction signals a critical juncture requiring fundamental restructuring and strategic realignment, as stakeholders navigate an increasingly challenging operational environment. The deviation from anticipated growth trajectories necessitates a comprehensive reassessment of investment strategies and operational frameworks within this vital sector.

2. Venture Capital Funds

2.1 Fund Structure

Venture Capital Fund Structures in China: a Comprehensive Analysis

Legal framework and organisational structure

The limited partnership enterprise (LPE) dominates China's venture capital landscape, featuring a dual-tier management structure. General partners (GPs) serve as strategic architects, bringing expertise from elite consulting firms and entrepreneurial backgrounds, while bearing unlimited personal liability. Limited partners (LPs), comprising institutional investors, state-owned funds and international pension funds, provide capital while maintaining limited liability protection.

Alternative frameworks include AMAC-regulated private equity funds offering standardised compliance mechanisms, and contractual investment structures allowing greater operational flexibility. These frameworks reflect China's evolving financial governance landscape.

Governance and decision-making mechanisms

Investment governance centres on GPs as strategic operators, supported by Investment Committees comprising seasoned professionals and industry experts. This structure ensures multi-layered investment scrutiny and comprehensive

risk assessment. LPs maintain strategic oversight through carefully negotiated veto rights on fundamental fund matters, including strategy shifts and GP replacement considerations.

Corporate documentation framework

The governance architecture rests on four key documents:

- the Limited Partnership Agreement (LPA), serving as the constitutional document;
- Subscription Agreements governing capital commitments;
- Private Placement Memorandums (PPMs), detailing investment thesis and risk frameworks; and
- Side Letters, enabling bespoke arrangements with sophisticated investors.

Ecosystem participants and market context

The ecosystem comprises GPs from elite professional backgrounds, diverse LP constituencies, and custodian banks providing critical infrastructure. Recent trends indicate increasing regulatory sophistication, enhanced transparency requirements and growing institutional participation, reflecting China's integration with global financial standards.

This sophisticated venture capital framework balances operational flexibility with strategic governance, establishing a robust foundation for China's evolving investment landscape.

2.2 Fund Economics

Primary Economic Participation Mechanisms

Management fee structure

Fund operations are sustained through a standard 2% annual management fee, calculated on committed capital during the investment period and deployed capital during the harvest phase. This structure ensures operational sustainability while providing base compensation for Fund Principals and covering essential management costs.

Carried interest framework

The carried interest mechanism allocates 20% of fund profits to Fund Principals, subject to an 8% hurdle rate. This performance-based compensation activates only after LPs recover their initial investment, creating a strong alignment of interests between fund managers and investors.

Market standard terms

Investor protection mechanisms include an 8% preferred return requirement and comprehensive claw-back provisions, enabling recovery of excess carried interest distributions. The governance framework implements high water mark principles to prevent carried interest on unrealised gains, while requiring significant personal capital commitment (1%–5%) from the management team.

This economic structure creates a balanced ecosystem that aligns manager incentives with investor interests while maintaining robust protective mechanisms for all stakeholders.

2.3 Fund Regulation

Regulatory Framework for Chinese Venture Capital

Securities investment fund law

The foundational regulatory framework establishes comprehensive guidelines for fund establishment, operations and investor protection. This legislation defines permissible investment strategies, risk management protocols and fundamental legal infrastructure, ensuring systematic oversight of investment activities.

AMAC regulations

The Asset Management Association of China (AMAC) mandates compulsory registration and compliance for all venture capital funds. Requirements encompass detailed information submission, ongoing reporting obligations and periodic regulatory reviews. This framework standardises industry practices while implementing robust monitoring mechanisms for investor protection.

Foreign exchange regulations

The State Administration of Foreign Exchange (SAFE) oversees a specialised framework for funds involving foreign LPs or cross-border investments. The system manages capital contribution restrictions, investment return repatriation and currency conversion protocols, reflecting China's balanced approach to international capital flows while maintaining careful economic oversight.

2.4 Particularities

Evolving Fund Structures in Chinese Venture Capital

Government-backed venture capital funds

Government guidance funds (GGFs) serve as strategic drivers of national innovation, focusing on critical sectors such as semiconductors, AI and clean energy. These funds align with national initiatives such as Made in China 2025 and the Dual Circulation Strategy, significantly influencing private venture capital investment patterns.

Impact funds and ESG integration

The market shows increasing adoption of ESG principles and impact investing, particularly in green technology, healthcare innovation and educational technology. Government support through financial subsidies and regulatory incentives reinforces this trend, emphasising renewable energy and sustainable innovation.

Funds-of-funds (FoFs) and continuation funds

FoFs, predominantly backed by government guidance funds, provide strategic diversification across multiple venture capital investments. Continuation funds offer innovative life cycle management solutions, extending investment horizons and maximizing portfolio returns. This structure supports a growing secondary market for venture capital fund interests.

Foreign participation and extended holding periods

International engagement operates within a controlled framework through Qualified Foreign Limited Partnership (QFLP) programmes. The ecosystem addresses extended holding periods through innovative approaches, including extended fund durations (12–15 years) and strategic co-investment structures.

3. Investments in Venture Capital Portfolio Companies

3.1 Due Diligence

Corporate Structure and Ownership

Due diligence begins with thorough shareholder verification, examining registered and beneficial ownership structures, undisclosed equity agreements and preference rights. Corporate governance review encompasses incorporation documents, subsidiary structures and governance mechanisms.

Regulatory and Permits

The process validates business licences, sector-specific compliance and alignment with foreign investment regulations.

Contractual Framework

Critical contract analysis covers material agreements, employment arrangements and financial

commitments, including detailed examination of security interests and governmental registrations.

Intellectual Property

Intellectual property (IP) verification focuses on ownership confirmation, registration status and licensing agreements, while implementing comprehensive risk mitigation strategies.

Dispute Management

Litigation assessment examines pending disputes, historical proceedings and compliance with judicial decisions.

ESG and Local Context Considerations

Environmental compliance, labour practices and governance mechanisms undergo systematic evaluation. The process incorporates unique Chinese market characteristics, including guanxi networks and dynamic regulatory environments, while maintaining rigorous verification standards.

3.2 Process

Investment Round Timeline and Collaboration Framework

Due diligence timeline structure

Early-stage venture capital rounds typically conclude within two to four weeks, reflecting simpler corporate structures and streamlined diligence requirements. Late-stage private equity rounds extend to four to six weeks, accommodating more complex corporate arrangements and comprehensive stakeholder considerations.

Collaborative legal framework

Investors generally engage shared counsel for comprehensive due diligence, with costs typically reimbursed by the company. This collective approach enhances efficiency while reducing redundant investigations. Each investor may retain separate counsel for term negotiations, enabling protection of specific interests within the collaborative framework.

Stakeholder dynamics

The process balances existing investor insights with new investor perspectives, creating a dynamic ecosystem that preserves historical context while incorporating fresh strategic input. This structure maintains efficient collective progress while protecting every single investor's interests throughout the financing round.

This balanced approach optimises the investment process through structured collaboration while preserving individual stakeholder protections.

3.3 Investment Structure

Preferred Equity Structures in Chinese Venture Capital

Contractual framework

Given the absence of formal *"preferred share"* classification under PRC law, investors utilise contractually engineered equity interests to establish preferential rights. This innovative approach mirrors common law preferred share characteristics while accommodating Chinese regulatory requirements.

Key preferential rights

These include:

- dividend preference;
- liquidation preference;
- redemption rights;
- anti-dilution adjustments;
- pre-emptive rights;
- right of first refusal (ROFR);
- co-sale rights;
- drag-along rights; and
- protective provisions (veto rights).

Implementation strategy

The structure balances robust investor protection with operational flexibility, tailoring rights to specific investment stages and company trajectories. This framework demonstrates the sophisticated legal engineering prevalent in Chinese venture capital, effectively bridging regulatory constraints through contractual innovation.

This approach creates a comprehensive preferred equity framework that maintains investor protection while adhering to Chinese legal requirements.

3.4 Documentation

Core Document Framework

This framework encompasses the following.

- Equity/share subscription/purchase agreement:
  - (a) investment terms and equity allocation;
  - (b) closing conditions;
  - (c) comprehensive representations and warranties; and
  - (d) indemnification provisions.
- Shareholders' agreement:
  - (a) inter-shareholder relationship governance;
  - (b) investor rights and protections;
  - (c) exit mechanisms and transfer restrictions; and
  - (d) corporate governance framework.
- Articles of association:
  - (a) fundamental corporate governance structure;
  - (b) internal operational rules; and
  - (c) a legally registered constitutional document.

Template Ecosystem

Unlike the standardised NVCA framework, Chinese venture capital relies on proprietary law firm templates. While maintaining consistent structural approaches across funds, these templates allow significant customisation for specific transactions. The ecosystem facilitates template sharing and adaptation while reflecting evolving market practices.

Documentation Strategy

Law firms maintain comprehensive template libraries serving as negotiation starting points. This approach enables sophisticated investment structures while preserving flexibility for unique circumstances, creating a balanced framework that supports efficient deal execution while accommodating transaction-specific requirements.

3.5 Investor Safeguards

Liquidation Preference Structure

Seniority frameworks establish hierarchical distribution rights based on investment stage and valuation. Recent market trends show increasing adoption of *"double dipping"* mechanisms, allowing investors to both recover initial investment with interest and participate in remaining distributions ratably, enhancing downside protection and upside gains.

Anti-Dilution and Pre-Emptive Rights

Anti-dilution protection primarily utilises the Weighted Average Method, adjusting investor ownership based on subsequent financing amounts and pricing. Pre-emptive rights, standard in Chinese venture capital, enable existing investors to maintain proportional ownership through priority participation in new share issuances.

Redemption Framework

Redemption rights provide strategic exit options through:

- defined activation timeframes;
- predetermined redemption pricing;
- performance-linked triggers; and
- structured payment mechanisms.

Market Dynamics

The ecosystem demonstrates increasing sophistication in investor protections, particularly in downside scenario provisions. This evolution reflects adaptive responses to changing market conditions and investment risk profiles, creating a more robust protection framework for investors.

3.6 Corporate Governance

As passive shareholders, financial investors commonly rely on pro investor governance mechanisms in venture investments.

Governance Influence Strategies

These include shareholder/board level protective provisions, as follows.

- Critical corporate matters:
  (a) liquidation or dissolution;
  (b) a change-of-control deal;
  (c) IPO;
  (d) related party transactions;
  (e) disposal of major assets;
  (f) significant corporate restructuring; and
  (g) board composition.
- Financial matters:
  (a) budget approvals;
  (b) capital expenditure thresholds;
  (c) debt incurrence; and
  (d) annual financial plans.
- Strategic decisions:
  (a) material business strategy changes;
  (b) mergers and acquisitions;
  (c) entry into new business lines; and
  (d) significant contractual commitments.

Governance Characteristics

These include a primarily passive investment approach focused on downside protection, indirect management influence, and being structured to prevent value-destructive decisions.

Mechanism of Influence

Contractually defined governance rights are carefully negotiated in shareholders' agreements, and are balanced to protect investor interests while maintaining management flexibility.

3.7 Contractual Protection

Representations, Warranties and Indemnification

The representations and warranties framework encompasses the following.

- Corporate fundamentals:
  (a) legal establishment and existence;
  (b) corporate authorisation validity;
  (c) accurate capitalisation structure; and
  (d) incorporation compliance.
- Operational assurances:
  (a) financial statement accuracy;
  (b) asset ownership verification;
  (c) IP rights confirmation; and
  (d) material contract validation.
- Compliance certifications:
  (a) regulatory adherence;
  (b) employment law compliance;
  (c) ESG standard conformity; and
  (d) data protection protocols.

Covenant Structure

This encompasses the following.

- Operational commitments:
  (a) ongoing regulatory compliance;
  (b) business continuity maintenance; and
  (c) asset preservation requirements.

- Restrictive provisions:
  (a) non-compete obligations;
  (b) confidentiality requirements; and
  (c) corporate change limitations.

Indemnification Framework

This encompasses the following.

- Compensation scope:
  (a) direct financial losses;
  (b) equity value diminution; and
  (c) transaction-related costs.
- Liability distribution:
  (a) company – primary indemnification responsibility; and
  (b) founders – joint liability with cap on their share' fair market value/markable value, unless the liability is due to fraud, wilful misconduct or gross negligence, where it is unlimited liability.

This framework establishes comprehensive protection mechanisms while maintaining practical enforceability within the Chinese legal context.

4. Government Inducements

4.1 Subsidy Programmes

Government Guidance Funds in Chinese Growth Investment

Strategic framework

Government guidance funds represent China's innovative approach to catalysing strategic investment, combining State direction with market dynamics. These funds strategically mobilise private capital into priority sectors while providing crucial risk mitigation mechanisms, effectively accelerating innovation and supporting economic transformation.

Priority investment sectors

The funds target five key strategic domains that align with China's long-term development goals:

- advanced manufacturing – focusing on smart manufacturing, robotics and Industry 4.0 initiatives;
- clean energy and sustainability – supporting renewable energy, energy storage and green technology;
- digital economy and AI – advancing cloud computing, big data analytics and AI applications;
- semiconductor technologies – developing domestic chip design, manufacturing and related equipment; and
- biotechnology and healthcare – investing in pharmaceutical research, medical devices and healthcare innovation.

Operational structure

The funds operate through a sophisticated investment approach that balances government oversight with market efficiency. This structure employs a private sector co-investment model, typically taking minority equity positions to maintain market dynamics while sharing investment risks. The focus on early-stage funding helps bridge critical financing gaps in emerging sectors.

Investment architecture

The operational framework is built on:

- multi-tiered investment vehicles that accommodate various risk profiles and investment horizons;
- professional management teams with both public and private sector expertise;
- market-driven methodology ensuring commercial viability; and

- flexible deployment criteria adapting to sector-specific needs.

4.2 Tax Treatment

Corporate Income Tax Structure

China's corporate tax framework balances standardised taxation with strategic incentives, creating a dynamic environment that supports innovation while maintaining fiscal stability. The system combines broad-based taxation with targeted benefits for strategic sectors and emerging companies.

Standard Tax Regime

The foundation of China's corporate taxation rests on a universal 25% Corporate Income Tax (CIT) rate, providing a consistent baseline across industries. This standard framework ensures regulatory clarity and establishes a level playing field for all business entities, while serving as the foundation for more specialised provisions.

Innovation Enterprise Benefits

To accelerate technological advancement and economic transformation, qualified innovation-driven enterprises enjoy significant tax advantages:

- preferential 15% CIT rate – available to companies meeting specific innovation criteria;
- priority sector focus – technology and AI development, biotechnology research and applications, green energy solutions and advanced manufacturing initiatives; and
- start-up support – special exemptions for early-stage companies, reducing initial tax burden during critical growth phases.

Investment Vehicle Taxation

The tax treatment of investment vehicles, particularly venture capital funds, aligns with international best practices while incorporating Chinese characteristics. The framework emphasises:

- limited partnership structures with tax pass-through benefits;
- direct taxation at the investor level rather than fund level;
- mechanisms to prevent double taxation across investment chains; and
- harmonisation with global investment standards to facilitate cross-border capital flows.

Geographic Tax Incentives

China leverages location-based tax policies to drive regional development and specialised industry clusters.

Strategic zones

Different specialised zones offer distinct advantages:

- special economic zones – comprehensive tax benefits supporting international trade;
- high-tech parks – focused incentives for technology development; and
- free trade zones – enhanced tax provisions for cross-border transactions.

Regional benefits package

Location-specific incentives include:

- reduced tax rates for qualified operations;
- strategic tax exemptions for priority industries; and
- investment subsidies promoting regional development goals.

4.3 Government Endorsement

China's Equity Financing Ecosystem: Market Evolution Framework

Stock market reform structure

China's equity market transformation represents a strategic shift towards greater market efficiency and accessibility, fundamentally reshaping the country's capital raising landscape.

Registration-based IPO system

The transition from an approval-based to a registration-based IPO system marks a significant evolution in China's capital markets. This modernised approach features:

- streamlined listing processes, reducing timelines to six months;
- market-driven valuation mechanisms, replacing administrative pricing;
- enhanced transparency requirements aligned with international standards; and
- progressive implementation across STAR Market and ChiNext Board.

Multi-tier market architecture

The ecosystem operates through strategically differentiated boards, each serving distinct company profiles.

- Main board – home to established corporations with proven track records.
- SME board – catering to growing mid-sized enterprises with stable operations.
- ChiNext – platform for high-growth innovative companies.
- STAR Market – specialised venue for cutting-edge technology firms, focusing on:
  (a) semiconductor development and production;
  (b) advanced manufacturing technologies; and
  (c) AI applications and biotechnology innovations.

International Integration Framework

Cross-border trading mechanisms

China has established robust international market connections through the following.

- Stock Connect programmes:
  (a) Shanghai-Hong Kong connection facilitating northbound/southbound trading;
  (b) Shenzhen-Hong Kong link expanding access to tech-focused enterprises; and
  (c) Bond Connect initiatives broadening fixed-income market access.
- QFII/RQFII reforms:
  (a) elimination of investment quotas;
  (b) simplified application procedures; and
  (c) improved market accessibility for global investors.

Global Listing Framework

Companies can optimise their capital-raising through multiple venues:

- Hong Kong – preferred regional hub offering regulatory familiarity and international exposure;
- NASDAQ – access to deep technology-focused investor base and global visibility; and
- alternative platforms – additional options through London and Singapore exchanges.

Global listing strategies prioritise high-growth sectors:

- technology and AI development;
- biotechnology innovation;
- advanced manufacturing capabilities; and
- digital economy initiatives.

5. Employment Incentives

5.1 General

Comprehensive Retention Framework

Chinese venture investments employ a sophisticated combination of legal obligations and incentive structures to ensure long-term commitment from founders and key employees, creating a balanced approach between enforcement and motivation.

Contractual Commitment Mechanisms

Non-compete provisions

The cornerstone of contractual retention includes carefully structured non-compete clauses that extend across multiple timeframes:

- during the active employment period;
- throughout the equity ownership duration; and
- a two-year post-employment restriction period.

Full-time contribution requirements

Comprehensive engagement obligations are structured to ensure dedicated focus and optimal performance. Mandatory engagement elements include:

- exclusive dedication to the venture's operations;
- explicit prohibition of parallel entrepreneurial activities; and
- specific performance metrics and time commitment standards.

Documentation framework

These obligations are formally documented across multiple agreements:

- Shareholders' Agreement (SHA) – governing equity holder obligations;
- Share Purchase Agreement (SPA) – establishing investment terms; and
- employment contracts – detailing day-to-day responsibilities.

Breach consequences

The framework includes clear enforcement mechanisms for commitment violations:

- SPA-triggered indemnity obligations for covenant breaches; and
- SHA-mandated redemption rights for a material breach.

Additional Retention Strategies

Performance-linked compensation involves a comprehensive incentive structure that complements legal obligations through various mechanisms, as follows.

- Equity-based incentives:
  (a) traditional stock option programmes with vesting schedules;
  (b) restricted share units (RSUs) aligned with performance metrics;
  (c) phantom equity arrangements for flexible value sharing; and
  (d) long-term bonus structures tied to company milestones.
- Strategic implementation – the compensation framework is designed to:
  (a) align individual interests with company success;
  (b) create meaningful long-term value potential;
  (c) establish clear performance-reward relationships; and
  (d) support retention through extended vesting periods.
- Integration and balance – this multifaceted approach creates a robust retention framework that:

(a) combines protective legal measures with positive incentives;
(b) balances immediate restrictions with long-term rewards;
(c) provides clear consequences while offering growth opportunities; and
(d) maintains flexibility while ensuring commitment.

5.2 Securities

Equity Retention and Incentive Mechanisms for Founders and Employees

Founder equity framework – restricted share mechanisms

Founder equity retention rests on a sophisticated vesting framework that balances long-term commitment with flexibility.

Vesting structure

- Time-based vesting:
  (a) four-year vesting schedule with one-year cliff;
  (b) monthly or quarterly vesting; and
  (c) accelerated vesting provisions for qualifying events (M&A/IPO).

Repurchase rights

The company maintains strategic control through carefully structured repurchase provisions.

Trigger events

- voluntary departure; and
- termination scenarios (with/without cause).

Valuation framework

- Unvested shares: repurchase at original cost.
- Vested shares:
  (a) at cost – voluntary departure or for-cause termination; and
  (b) fair market value – termination without cause or *"good reason"*.

Employee equity participation

Employee participation is facilitated through a comprehensive stock option framework:

- implementation through an LP structure;
- employee access via LP interests; and
- five-year standard vesting timeline promoting long-term alignment.

The framework combines multiple vesting approaches:

- a time-based vesting schedule; and
- performance-based acceleration opportunities.

Integration and impact

This comprehensive framework represents a sophisticated approach to equity-based retention and motivation. It effectively balances:

- short-term performance incentives with long-term value creation;
- individual reward potential with company risk management; and
- standardised structures with situation-specific flexibility.

5.3 Taxation of Instruments

Employee Stock Option Plan (ESOP) Taxation Framework in China – LP ESOP Structure

Tax-efficient configuration

China's ESOP framework utilises an LP structure that optimises tax efficiency through:

- transparent tax treatment enabling direct pass-through;
- elimination of entity-level double taxation;
- direct attribution of tax obligations to individual participants; and
- structure alignment with global taxation standards.

Individual income tax assessment

The primary taxable event occurs at option exercise, with careful consideration of the following.

Tax base calculation

- Determined by the differential between:
  (a) current fair market value (FMV) of shares; and
  (b) original option exercise price.

Progressive tax rate application

- Rates scale from 3% to 45% based on income levels.
- Comprehensive income consideration, including:
  (a) regular employment income;
  (b) option exercise benefits; and
  (c) other taxable income sources.

Capital gains taxation

Partnership interest disposal – tax rate structure

- Standard capital gains rate – 20%.
- Alternative rate schedule – up to 35%:
  (a) applied based on specific circumstances;
  (b) consideration of holding periods; and
  (c) assessment of disposal volume.

Geographic considerations

Tax obligations vary based on location-specific factors:

- municipal-level regulations;
- economic development zone benefits; and
- special economic region provisions.

Strategic tax planning

Effective ESOP implementation requires careful consideration of:

- optimal exercise timing;
- strategic disposal planning;
- geographic tax arbitrage opportunities; and
- available tax relief mechanisms.

Documentation requirements

Proper tax treatment depends on maintaining:

- detailed exercise records;
- FMV assessments;
- holding period documentation; and
- disposal transaction records.

Geographic benefits

Various locations offer distinct advantages:

- economic development zones providing preferential rates;
- special economic regions with tax incentives; and
- municipal-level tax benefits for qualifying transactions.

Timing strategies

Tax efficiency can be enhanced through:

- strategic exercise timing;
- planned disposal schedules;
- co-ordination with other income sources; and
- utilisation of tax assessment periods.

5.4 Implementation

ESOP and Equity Framework for Chinese Companies – Core Structure and Implementation

Equity pool configuration

A standard allocation range of 10%–20% of total equity applies:

- implemented through an LP structure with tax pass-through mechanisms;
- featuring flexible sizing based on company stage, industry characteristics and talent strategy requirements; and
- supported by systematic dilution management across funding rounds.

Stage-Specific Implementation

Early stage (Seed/Series A)

This involves an initial pool of 10%–15% of total equity with broader distribution patterns focused on early team building, featuring generous individual allocations to attract key talent, and supported by flexible grant structures that enable rapid team expansion and critical role fulfilment.

Growth stage (Series B/C)

This involves dynamic pool adjustments with refined allocation strategy, incorporating performance-linked grants and sophisticated vesting mechanisms, balanced with proportional dilution management and strategic pool replenishment to maintain incentive effectiveness.

Late stage (pre-IPO)

This involves conservative new allocations emphasising retention through sophisticated vesting mechanisms, minimal dilution impact, and performance-based equity distribution, focused on key talent retention and value preservation approaching liquidity events.

Retention and Protection Mechanisms

Vesting framework

This involves a comprehensive four to five-year vesting schedule with a one-year cliff period, featuring monthly or quarterly accrual post-cliff, strategic acceleration provisions for M&A and IPO scenarios, as well as performance-based vesting criteria linked to both company and individual achievements.

Protection features

These include robust company repurchase rights triggered by departure events, with differentiated valuation mechanisms for unvested shares (at cost) and vested shares (based on departure circumstances), complemented by comprehensive non-compete provisions, full-time commitment requirements, and IP protection measures.

Taxation Structure

Exercise taxation

Tax base is calculated as FMV minus exercise price, subject to progressive rates from 3%–45%, incorporating strategic timing considerations for exercise and disposal, with geographic variations offering potential tax advantages based on local jurisdiction policies.

Capital gains treatment

A standard capital gains rate of 20% applies with an alternative rate of up to 35%, featuring regional variations based on economic zone benefits, municipal regulations and special region provisions, supported by systematic tax optimisation strategies and professional advisory guidance.

Strategic Implementation

Value optimisation

This involves industry-aligned allocation ranges with market-competitive individual grants, incorporating performance linkage mechanisms and regular value assessment, and supported by systematic review processes and adjustment capabilities to maintain competitive positioning.

Risk management

This involves comprehensive dilution control mechanisms integrated with clear documentation requirements, regular compliance monitoring and stakeholder protection measures, balanced with flexibility for market dynamics and company growth requirements.

Integration Framework

Corporate alignment

This involves strategic alignment between equity compensation and corporate objectives, supporting talent acquisition and retention, performance motivation and value creation, while enabling sustainable growth and stakeholder value enhancement.

Governance structure

This is a robust governance framework featuring regular review mechanisms, transparent communication protocols and professional advisory support, ensuring consistent compliance management and effective programme administration.

Implementation Considerations

Practical execution

A systematic implementation approach combines clear communication strategies, regular performance assessment, documented review processes and flexible adjustment mechanisms, supported by professional advisory services and stakeholder engagement.

Market context

The framework reflects the evolution of Chinese equity compensation practices, demonstrating a sophisticated approach to talent retention while balancing international standards with local market requirements, regulatory compliance and stakeholder interests.

6. Exits

6.1 Investor Exit Rights

Exit Strategies and Shareholder Rights Framework: Core Exit Mechanisms

Drag-along rights

A comprehensive majority investor mechanism enables forced sale participation across all shareholders, providing transaction completion assurance and control premium preservation, while eliminating minority blocking positions and establishing clean exit pathways for trade sales, liquidity events and strategic transactions.

Tag-along/co-sale rights

A robust investor protection framework ensures equitable exit opportunities through guaranteed participation in founder-initiated sales, maintaining transaction term parity and proportional participation, while preventing discriminatory conditions and mitigating valuation disparities across shareholder classes.

Redemption rights

A structured investor exit guarantee system is activated by specific milestones or trigger events, including failed IPO attempts, missed strategic objectives or extended investment periods, and material breaches of representations or covenants, executed through company-funded redemption, founder-led share buybacks or predetermined valuation formulas.

Value Protection Structure

Liquidation preferences

A sophisticated priority distribution framework provides preferred shareholder protection through multiple structures (participating, non-participating, capped preferences), establishing clear hierarchical recovery mechanisms for investor capital protection and downside risk mitigation.

Transfer Restriction Mechanisms

Founder transfer constraints

Comprehensive restrictive transfer protocols require investor consent, strategic holding periods and structured approval processes, balanced with company growth requirements and market dynamics.

Right of first refusal

This involves a founders' share transfer process that incorporates investor right of first refusal (ROFR), mandatory offer notifications and opportunity matching for third-party terms, supported by structured transfer approval protocols and stakeholder protection measures.

Investor Transfer Guidelines

The nuanced transfer framework incorporates competitive restrictions, prohibited sales to predefined competitors and strategic market protection measures, while maintaining appropriate transaction flexibility.

Implementation Framework

Documentation requirements

The comprehensive legal framework incorporates detailed shareholders' agreement provisions, clear trigger event definitions, structured valuation methodologies and systematic process execution protocols, supported by professional advisory guidance.

Execution mechanisms

Standardised implementation procedures feature clear notification requirements, defined response timelines, transparent pricing mechanisms and established dispute resolution protocols, ensuring consistent and efficient execution.

Strategic Considerations

Value optimisation

This involves a systematic approach to transaction timing, valuation maximisation and stakeholder alignment, incorporating market condition assessments and strategic positioning to enhance exit outcomes.

Risk management

The comprehensive protection framework balances minority shareholder rights with majority control, ensuring fair treatment across shareholder classes while maintaining flexibility for market dynamics and growth requirements.

Practical Application

Exit preparation

The strategic preparation framework combines timing assessment, stakeholder communication, documentation readiness and process optimisation, supported by professional advisory services and systematic review procedures.

Transaction execution

A structured execution approach incorporates clear approval processes, transparent communication protocols and comprehensive compliance management, ensuring efficient and equitable transaction completion.

6.2 IPO Exits

Traditional Market Foundation

A-Share market position

The A-Share market stands as China's traditional cornerstone for corporate exits, offering domestic prestige combined with streamlined regulatory navigation. This primary route leverages established domestic investor relationships and regulatory familiarity, providing natural advantages in market understanding and compliance efficiency. Companies benefit from cultural alignment and simplified communication channels,

particularly valuable for enterprises with strong domestic market presence.

Regulatory environment

The China Securities Regulatory Commission's (CSRC) oversight has evolved into a sophisticated framework emphasising stringent listing requirements and enhanced financial scrutiny. Modern regulatory focus centres on financial transparency, corporate governance excellence and business model sustainability, while maintaining robust anti-speculation measures. This environment demands thorough operational history validation and precise financial performance documentation, creating a comprehensive but navigable regulatory landscape.

Market Dynamics

Contemporary challenges

Market conditions present complex challenges through macroeconomic uncertainties and sector-specific variations. The listing environment features extended review timelines and heightened rejection risks, requiring sophisticated preparation strategies. Companies must navigate valuation volatility while maintaining flexibility in market access timing and implementation approaches.

Strategic response

Successful navigation requires balanced preparation incorporating financial readiness, governance enhancement and stakeholder communication. Companies must maintain adaptable timelines while ensuring comprehensive documentation and professional advisory support, enabling responsive adjustment to market conditions while preserving strategic objectives.

International Listing Framework

Hong Kong Exchange (HKEX) pathway

HKEX offers a strategic hybrid platform combining international market access with regional proximity advantages. This route provides familiar regulatory frameworks aligned with international standards while maintaining strong mainland connections. Companies benefit from enhanced global visibility while leveraging existing cultural and operational synergies.

NASDAQ positioning

NASDAQ listings deliver advanced international market integration and sophisticated infrastructure access. This pathway particularly suits technology-driven enterprises seeking global ecosystem integration and institutional investor exposure. Companies gain access to deep liquidity pools and comprehensive research coverage while meeting elevated international standards.

Implementation Strategy

Location selection

Venue selection demands systematic evaluation of market depth, regulatory requirements and investor base characteristics. Analysis must balance quantitative metrics with qualitative factors including peer group alignment and index inclusion potential, while maintaining focus on long-term strategic objectives.

Preparation framework

Successful execution requires meticulous financial preparation, governance enhancement and compliance readiness. Companies must develop comprehensive stakeholder communication strategies while maintaining flexibility for evolving market conditions and regulatory requirements.

Risk Management

Regulatory navigation

Effective risk management combines multi-jurisdictional compliance expertise with systematic monitoring of market conditions. Companies must maintain robust contingency planning while ensuring responsive adaptation to regulatory developments and market sentiment changes.

Market timing

Strategic timing optimisation requires balanced consideration of market conditions, valuation environments and investor sentiment. Companies must maintain preparation readiness while preserving flexibility to capture optimal market windows.

Future Outlook

Market evolution

Capital markets continue advancing through regulatory modernisation and international integration enhancement. Evolution encompasses increasing sophistication in trading mechanisms and valuation methodologies while maintaining focus on market stability and investor protection.

Strategic adaptation

Forward-looking planning must incorporate emerging opportunities and regulatory changes while maintaining core strategic alignment. Companies must balance traditional market strengths with international opportunities while ensuring sustainable competitive positioning.

6.3 Pre-IPO Liquidity

Secondary Market Trading and Liquidity Mechanisms in the Chinese Venture Ecosystem

Market liquidity landscape and emerging secondary market dynamics

The Chinese venture ecosystem faces significant liquidity challenges stemming from traditional exit limitations, including extended IPO timelines, persistent regulatory uncertainties and prolonged investment holding periods. These challenges directly impact various stakeholders' needs, particularly in investor capital optimisation, employee equity monetisation and portfolio management flexibility. The evolving landscape necessitates innovative approaches to address these fundamental market constraints.

Structured liquidity mechanisms and secondary trading frameworks

To address market inefficiencies, emerging liquidity solutions have developed through structured approaches encompassing controlled secondary transactions, investor-to-investor transfers and company-facilitated trading platforms. These solutions are implemented through carefully regulated transfer mechanisms, transparent valuation processes and comprehensive compliance protocols, ensuring market integrity while facilitating necessary liquidity.

Regulatory and structural barriers in secondary market development

The development of robust secondary markets faces substantial impediments, including limited market infrastructure, strict transfer restrictions and complex compliance requirements. These challenges are compounded by valuation complexities, characterised by inconsistent pricing mechanisms, significant information asymmetry and limited market transparency, creating barriers to efficient secondary market operations.

Legal and governance framework

Successful secondary market operations require well-structured legal parameters, including comprehensive shareholders' agreements, clear transfer restriction provisions and detailed valuation methodologies. These are supported by robust governance mechanisms incorporating

board approval processes, right-of-first-refusal protocols and investor consent requirements, ensuring orderly market function while protecting stakeholder interests.

Future outlook

The Chinese venture ecosystem's secondary market is poised for continued evolution, with developments expected in trading mechanisms, more sophisticated liquidity solutions and increased regulatory clarity. These advancements will likely facilitate more efficient capital recycling and improved market functionality, benefiting all ecosystem participants.

7. Regulation

7.1 Securities Offerings

Regulatory Foundation

Legal ecosystem integration

The Chinese equity securities framework operates within an intricate regulatory ecosystem, integrating multiple legal domains including corporate law, securities regulations, foreign investment frameworks, employment legislation and tax compliance mechanisms. This multidimensional legal structure requires sophisticated navigation of intersecting regulatory requirements while maintaining operational efficiency and strategic flexibility in transaction execution.

Regulatory oversight structure

Primary regulatory oversight combines the coordinated efforts of key authorities including the CSRC, the Ministry of Commerce (MOFCOM), SAFE and the National Tax Administration. This integrated regulatory approach demands comprehensive cross-jurisdictional compliance while maintaining holistic regulatory perspective across all transaction dimensions.

Transaction Framework

Structural implementation

Transaction execution requires navigation of sophisticated compliance requirements through adaptable offering structures and flexible equity distribution mechanisms. This framework incorporates detailed documentation protocols while implementing tax efficiency strategies through optimised equity allocation and transfer pricing mechanisms, ensuring minimised tax burden within regulatory constraints.

Operational framework

Practical implementation encompasses systematic management of regulatory approval processes, including detailed documentation requirements and complex approval hierarchies. This operational structure requires proactive regulatory navigation supported by comprehensive due diligence and adaptive compliance strategies, ensuring sustainable transaction execution while maintaining regulatory alignment.

Legal Architecture

Corporate governance framework

Governance structures incorporate detailed shareholders' agreement provisions covering comprehensive equity offering terms, transfer restriction protocols and rights definition. Articles of association provide foundational support through detailed equity issuance guidelines, governance structure specifications and robust investor protection mechanisms, ensuring comprehensive stakeholder protection.

Securities regulation compliance

Securities compliance demands comprehensive information transparency through detailed financial reporting and investor protection mechanisms. This framework requires systematic documentation processes, precise regulatory submissions and comprehensive compliance

verification, maintaining regulatory alignment while preserving transaction efficiency.

International Investment Integration

Cross-border transaction management

International investment frameworks require sophisticated navigation of foreign investment review processes, capital control regulations and cross-border transfer restrictions. This structure demands adaptive investment mechanisms and comprehensive regulatory navigation strategies, ensuring successful cross-border transaction execution while maintaining compliance integrity.

Future Development Trajectory

Evolution dynamics

Market evolution continues through increasing regulatory sophistication and enhanced compliance frameworks. This development encompasses more integrated regulatory approaches and continued market evolution, requiring adaptive strategic responses and sophisticated compliance mechanisms.

Strategic adaptation

Forward-looking planning must incorporate emerging regulatory trends and evolving market requirements while maintaining operational efficiency. This approach enables sustainable transaction execution through adaptive compliance strategies and sophisticated structural solutions.

7.2 Restrictions

Foreign Venture Capital Investment: Chinese Regulatory Framework

The Dynamic Investment Environment

The Chinese foreign investment landscape operates within an evolving regulatory ecosystem characterised by multidimensional restriction mechanisms encompassing FDI regulations, currency controls, sector-specific limitations and national security considerations. This adaptive framework demonstrates continuous policy refinement reflecting geopolitical sensitivities and strategic economic alignment, requiring sophisticated navigation of dynamic regulatory requirements. The system maintains a systematic balance between investment attraction and market protection through comprehensive control mechanisms while enabling sustainable market development trajectories aligned with national strategic objectives.

Strategic Regulatory Architecture

The regulatory structure implements sophisticated oversight through integrated control mechanisms and strategic sector development initiatives. This comprehensive framework enables measured economic openness while preserving critical national interests through systematic monitoring and adaptive policy implementation. The architecture demonstrates increasing sophistication in balancing foreign participation with domestic market development, supported by enhanced compliance mechanisms and strategic sector alignment protocols.

Foreign Direct Investment Framework

Negative list mechanism

The negative list system provides comprehensive investment restriction frameworks through precise industry categorisation and dynamic restriction protocols. Annual regulatory updates ensure alignment with strategic economic objectives while maintaining systematic sector protection mechanisms. This structure enables clear operational guidance for foreign investors while preserving flexibility for policy adjustment and strategic sector development, supported by sophisticated compliance verification systems and detailed implementation protocols.

Industry classification framework

Prohibited sectors

Absolute restriction domains encompass strategically sensitive sectors including news media, publishing, cultural production and specific financial services. This framework maintains cultural integrity and information ecosystem control while preserving core national sovereignty interests through comprehensive restriction mechanisms. The system implements sophisticated monitoring protocols and systematic compliance verification while maintaining clear boundaries for foreign participation across restricted sectors.

Restricted industries

Controlled foreign participation frameworks govern strategic sectors including telecommunications, education and healthcare through sophisticated investment constraint mechanisms. These frameworks integrate detailed equity ownership caps, mandatory approval processes and comprehensive qualification requirements, while maintaining systematic oversight of foreign participation. The structure enables measured market access while preserving regulatory control through integrated monitoring systems and adaptive compliance requirements.

Encouraged sectors

Strategic investment promotion focuses on targeted sector development through sophisticated incentive mechanisms including tax optimisation strategies and streamlined approval processes. This framework provides preferential policy access and simplified regulatory navigation while maintaining alignment with national development objectives. The system implements comprehensive support mechanisms while ensuring appropriate oversight and compliance verification through integrated monitoring protocols.

Currency Control Architecture

SAFE regulatory framework

SAFE maintains comprehensive capital flow management through sophisticated cross-border transaction governance. This integrated system combines mandatory investment registration, detailed reporting protocols and systematic compliance verification, while enabling controlled capital movement. The framework implements comprehensive monitoring mechanisms while maintaining necessary flexibility for legitimate investment operations through sophisticated control protocols.

Capital movement mechanisms

The capital movement structure implements sophisticated regulatory controls through integrated approval processes and systematic compliance verification. This framework enables controlled capital flows while maintaining market stability through comprehensive monitoring systems and adaptive control mechanisms. The structure demonstrates increasing sophistication in balancing transaction efficiency with regulatory oversight, supported by enhanced verification protocols and strategic risk management systems.

Free Trade Zone Innovation

Strategic pilot programmes

Breakthrough regulatory approaches in pilot free trade zones demonstrate measured market opening through controlled foreign participation in strategic sectors. These programmes implement systematic innovation within controlled regulatory frameworks while maintaining comprehensive oversight mechanisms. The structure enables targeted experimentation with regulatory reforms while preserving strategic control through integrated monitoring systems and adaptive compliance requirements.

Innovation ecosystem development

Key pilot regions including Beijing, Shanghai, Guangdong and Hainan Free Trade Zones provide comprehensive innovation ecosystems through systematic policy experimentation and gradual regulatory liberalisation. These controlled innovation corridors enable measured testing of regulatory reforms while maintaining strategic oversight through sophisticated monitoring protocols and integrated compliance systems. The framework demonstrates increasing sophistication in balancing innovation promotion with regulatory control through enhanced verification mechanisms and strategic alignment protocols.

In a landmark policy shift for 2024, China significantly opened its gene therapy sector to foreign investment, marking a strategic departure from its traditionally prohibited stance. Through a carefully structured pilot programme in designated free trade zones, foreign enterprises can now invest in and develop technologies across key areas including human stem cell research, gene therapy, genetic diagnosis and cell therapy applications. This policy change not only demonstrates China's commitment to advancing its biotechnology sector but also creates unprecedented opportunities for international collaboration and knowledge transfer.

While maintaining necessary regulatory oversight and compliance requirements, this opening is expected to accelerate China's development in advanced medical treatments by attracting substantial foreign expertise and capital. The move reflects China's broader strategy of strengthening its position in the global biotechnology landscape while ensuring controlled and regulated market access for foreign participants in this sensitive healthcare sector.

Trends and Developments

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Zhong Lun Law Firm was established in 1993, and is a pioneering partnership law firm in China. Through decades of strategic growth and unwavering commitment to excellence, the firm has emerged as a pre-eminent full-service law firm. With nearly 400 equity partners and a robust team of over 2,200 professionals, Zhong Lun represents the pinnacle of legal expertise and institutional capability. As one of the first Chinese law firms to specialise in private equity, Zhong Lun has developed unparalleled insights and deep-rooted expertise in this complex domain. Its practice comprehensively addresses the entire life cycle of private fund operations. By combining meticulous legal acumen with strategic foresight, the firm has consistently positioned itself as a leading legal service provider in China's dynamic private equity landscape. Its sustained excellence has been internationally recognised, with Chambers Global repeatedly ranking Zhong Lun in Band 1 for Private Equity – a testament to the firm's exceptional performance and industry leadership.

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China's Private Equity Sector: Legal and Regulatory Perspective

China's private equity (PE) and venture capital (VC) landscape experienced substantial legal and regulatory transformation throughout 2024, influenced by economic restructuring initiatives, technological innovation, geopolitical tensions and an intensified focus on compliance frameworks and market stability. This analysis offers a comprehensive examination of pivotal trends and developments through a legal and regulatory lens in China's PE and VC sector.

Key Trends and Challenges

Overall decline in deal flow

The Chinese PE and VC markets have undergone significant recalibration over the preceding three-year period, characterised by a pronounced contraction in both transaction volume and deal valuation. Market intelligence spanning from 2022 through 2024 revealed several defining trends and contributory factors. The following analysis explores these developments.

2022–2023 slowdown

The post-COVID-19 pandemic economic realignment, in conjunction with enhanced regulatory oversight and global macroeconomic volatility, precipitated a marked deceleration in transactional activity. The authors' analysis reveals a year-on-year contraction in both transaction frequency and aggregate value, with particular impact observed in previously high-performing sectors such as technology and consumer goods, which had historically served as primary growth catalysts.

2024 continuation

Current market indicators for 2024 demonstrated sustained investor circumspection, with transaction volumes remaining constrained. This persistent caution stems primarily from two key factors: increasingly stringent compliance frameworks (addressed comprehensively in subsequent sections) and ongoing geopolitical tensions that continue to impede cross-border capital mobility (examined in detail below).

Geopolitical challenges impacting Chinese PE and US investor reticence

Escalating geopolitical tensions and intensified regulatory examination, most notably through the Committee on Foreign Investment in the United States (CFIUS), have fundamentally altered cross-border investment paradigms, engendering pronounced reluctance among US

institutional investors regarding participation in Chinese PE vehicles. The following analysis delineates principal challenges and illustrative instances.

CFIUS scrutiny and regulatory hurdles

CFIUS has substantially expanded its supervisory purview over foreign capital deployments, with particular emphasis on transactions involving critical technologies, essential infrastructure and data-sensitive industrial sectors. CFIUS has articulated an evolving framework of national security considerations, necessitating more comprehensive and rigorous evaluations of transactions with nexus to nations designated as strategic competitors, most notably China. Illustrative examples include that:

- investments directed towards Chinese emerging technology enterprises are subject to elevated levels of regulatory examination regarding data security protocols and intellectual property protection mechanisms; and
- US institutional investors increasingly confront regulatory imperatives to divest holdings in Chinese ventures operating in strategically sensitive domains, including artificial intelligence systems, semiconductor development and manufacturing, and advanced biotechnology applications.

Structural decoupling of investment firms

In response to escalating CFIUS-associated regulatory contingencies, pre-eminent VC institutions have implemented comprehensive organisational restructuring of their China-focused operations:

- Sequoia Capital executed a strategic bifurcation of its Chinese investment platform, establishing the autonomous entity *"Hongshan"* in 2023, thereby creating distinct operational and governance firewalls between its US and Chinese investment portfolios; and
- GGV Capital similarly effectuated a corporate separation, reconstituting its China-centric investment activities under the independently managed *"Jiyuan Capital"* entity, exemplifying a broader industry-wide strategic realignment in response to evolving geopolitical imperatives.

These strategic corporate recalibrations underscore sophisticated risk mitigation methodologies designed to insulate global investment operations from potential regulatory interventions, while preserving access to regional market opportunities through legally differentiated corporate structures.

Geopolitical tensions and national security considerations

The strategic competition between the United States and China transcends the jurisdictional parameters of CFIUS, encompassing a comprehensive matrix of regulatory mechanisms including stringent export control regimes (exemplified by semiconductor technology transfer prohibitions), targeted economic sanctions, and allegations pertaining to intellectual property misappropriation. This multifaceted regulatory landscape engenders heightened political risk assessment protocols among institutional investors, precipitating substantial capital reallocation away from industrial sectors perceived as entangled in bilateral strategic competition dynamics.

Impact on cross-border capital flows

This impact has been seen in the following ways:

- diminution of US-originated investment capital – Chinese emerging technology enterprises operating within strategically sensitive industrial sectors report statistically

significant reductions in VC deployments from US-domiciled investment vehicles, with institutional allocators increasingly redirecting capital towards alternative regional markets, predominantly South-East Asian jurisdictions and the Indian subcontinent; and
- extended regulatory review periodicity – CFIUS evaluation procedures have demonstrably extended transaction timelines, substantially elevating both direct transaction costs and introducing material levels of execution uncertainty into cross-border investment structures involving Chinese entities.

Regulatory ambiguity and compliance complexity

This includes the following.

- Interpretive uncertainty in CFIUS guidance – the Committee's regulatory framework exhibits substantive ambiguity regarding critical operational domains, particularly with respect to data governance protocols and cross-border information transfer mechanisms, thereby compelling emerging technology enterprises to implement excessively conservative compliance strategies that potentially constrain legitimate business activities.
- Conflicting data sovereignty regimes – adherence to China's increasingly stringent data localisation mandates (codified within the comprehensive Cybersecurity Law, Personal Information Protection Law, and Data Security Law tripartite framework) creates fundamental compliance contradictions vis-à-vis US national security requirements. This regulatory incongruence introduces substantial operational complexities for multinational entities engaged in trans-Pacific commercial activities, necessitating sophisticated data architecture bifurcation and jurisdictionally segregated information management systems.

Summary: strategic implications for cross-border investment paradigms

The intricate interrelationship between heightened CFIUS enforcement protocols, escalating geopolitical strategic competition and accelerating institutional decoupling mechanisms have precipitated a fundamentally reconfigured operational landscape for trans-Pacific PE deployment. While pre-eminent investment institutions such as Sequoia Capital and GGV Capital have implemented sophisticated organisational bifurcation strategies to preserve market access, the pervasive regulatory indeterminacy and prioritisation of national security imperatives continue to function as material impediments to cross-border capital formation.

To maintain sustainable engagement in this complex jurisdictional environment, institutional investors must develop nuanced governance frameworks capable of simultaneously addressing dual regulatory pressures – implementing robust compliance architectures responsive to evolving US national security safeguards while concurrently navigating China's increasingly assertive regulatory sovereignty regime.

Strategic reorientation towards lower-quantum, targeted transactions

Early-stage capital deployment recalibration

In response to heightened regulatory scrutiny and enhanced national security review thresholds applicable to later-stage, high-valuation transactions, institutional investors have strategically reallocated capital towards early-stage venture investments characterised by reduced regulatory complexity. Notwithstanding this tactical portfolio adjustment, the diminished transaction quantum associated with such investments has precipitated a statistically significant contraction in aggregate deployed capital across the investment landscape.

Limited partner investment selectivity enhancement

Institutional limited partners, encompassing insurance-based investment vehicles and sovereign-affiliated investment entities, have implemented increasingly stringent fund selection criteria, demonstrating marked preference for established investment managers with demonstrable performance metrics across multiple economic cycles. This capital concentration phenomenon has engendered material adverse consequences for emerging fund managers, contributing to a pronounced reduction in transaction volume and competitive dynamics within the investment ecosystem.

ESG integration and comprehensive risk governance

The progressive incorporation of robust ESG criteria into investment evaluation frameworks has substantively expanded due diligence protocols and extended pre-investment analytical timelines. This enhanced scrutiny has resulted in elongated transaction execution periods and a corresponding diminution in average transaction size, as investors increasingly prioritise compliance assurance and risk mitigation over expeditious capital deployment.

Renminbi-denominated investment vehicle expansion and operational complexities

Renminbi-denominated investment vehicles have consolidated their predominant market position within China's PE ecosystem, propelled by favourable regulatory frameworks and substantial domestic liquidity mobilisation. Nevertheless, significant structural challenges persist within this capital formation environment, such as the following.

Diversification of limited partner capital sources

While sovereign-affiliated institutional investors – including the National Council for Social Security Fund (NCSSF) and China Development Bank – maintain their foundational limited partner status, ultra-high net worth individuals and sophisticated family office structures have emerged as increasingly significant capital contributors. Concurrently, insurance-based investment entities have systematically expanded their alternative asset allocations, continuing to operate within the regulatory parameters established by the 2010 Provisional Regulations on Insurance Capital Utilisation, which authorise deployment of up to 5% of insurance capital reserves into PE instruments – a regulatory framework that continued to exert material influence on institutional capital allocation strategies throughout 2024.

Jurisdictional tax efficiency optimisation

Differentiated provincial taxation incentive regimes designed to attract PE capital formation have successfully induced foreign investment management entities into establishing onshore fund structures. However, the heterogeneous implementation of preferential tax treatment and refund mechanisms across administrative jurisdictions has generated substantial compliance complexity and regulatory arbitrage opportunities, necessitating sophisticated tax governance frameworks.

Compressed investment horizon considerations

The accelerated proliferation of renminbi-denominated investment vehicles has engendered legitimate concerns regarding potentially abbreviated investment evaluation cycles and compromised due diligence protocols. Industry thought leaders have articulated substantive reservations regarding the prioritisation of expeditious liquidity events over sustainable value creation, advocating for the implementation of

more rigorous investment evaluation methodologies and extended value creation timelines among fund management entities.

Regulatory compliance framework enhancement and risk governance protocols

2024 witnessed a fundamental recalibration towards anticipatory compliance architectures and sophisticated internal governance mechanisms.

AMAC registration protocol intensification

Alternative investment management entities encountered increasingly stringent registration requirements, encompassing comprehensive internal control system audits and submission of independent legal opinions attesting to regulatory compliance. This enhanced regulatory oversight necessitated substantial operational restructuring among market participants to satisfy escalating compliance thresholds.

Systemic risk identification and mitigation strategies

Regulatory authorities implemented targeted enforcement initiatives addressing non-compliant practices, including improper asset reclassification methodologies and securities trading violations predicated on material non-public information. These enforcement protocols increasingly leveraged advanced data analytics capabilities to monitor capital movement patterns with unprecedented granularity. In response, PE institutions have accelerated deployment of artificial intelligence-enhanced compliance monitoring systems to ensure adherence to evolving regulatory expectations.

Industry-specific investment dynamics and regulatory considerations

Certain economic sectors attracted disproportionate regulatory scrutiny and institutional capital allocation.

Technology and digital infrastructure ecosystem

Investment activity in semiconductor manufacturing capabilities, artificial intelligence applications, and financial technology platforms experienced substantial acceleration, with regulatory authorities simultaneously encouraging technological innovation while implementing more stringent data security regulatory frameworks (exemplified by China's Data Security Law). Transaction due diligence protocols expanded significantly to incorporate comprehensive cybersecurity vulnerability assessments and data governance evaluations.

Life sciences and biotechnology advancement

Streamlined regulatory approval pathways for pharmaceutical products and medical device certifications established the healthcare sector as a prioritised destination for PE capital deployment. This regulatory efficiency enhancement substantially improved investment return potential through accelerated commercialisation timelines.

Real estate and energy infrastructure development

Enhanced regulatory oversight regarding leveraged capital structures in the real estate and energy sectors materially contributed to diminished transaction activity. Development initiatives requiring substantial capital expenditure (including infrastructure projects and commercial real estate developments) encountered significant challenges in securing equity financing.

The Impact of the New Company Law

China's 2024 Company Law introduced substantial amendments that significantly impact PE and VC transactions in China. The following analysis outlines the key implications for industry practitioners.

Capital contribution system

Five-year mandatory capital payment

The new legislation mandates that all shareholders of limited liability companies (LLCs) fulfil their subscribed capital contributions within five years of incorporation, eliminating the previously unrestricted timeframe. This provision applies retroactively to existing companies, necessitating that PE/VC investors reassess their portfolio companies' capital structures and negotiate appropriate adjustments (such as capital reductions or accelerated payment schedules). Consequently, start-ups with inflated registered capital or extended payment terms may face considerable liquidity constraints, potentially affecting valuations and exit timelines.

Enhanced liability for defaulting shareholders

Shareholders who fail to meet their capital contribution obligations now face explicit liability for compensatory damages to the company. Founders and early-stage investors may bear joint and several liability for unpaid capital during the company formation phase.

Equity transfers and liability allocation

Stricter rules for defective equity transfers

The transfer of unpaid or underpaid equity interests now imposes supplementary liability on transferors if transferees subsequently default. While transferees bear primary responsibility for unpaid capital, transferors may incur liability if transferees fail to fulfil their obligations. Transfers of non-monetary assets with inflated valuations trigger joint liability for both transferors and transferees, in the absence of a good faith defence by the transferee. Accordingly, PE/VC investors are advised to conduct thorough due diligence on historical capital contributions and to incorporate comprehensive indemnity provisions into transaction documentation.

Simplified transfer procedures

External equity transfers no longer require prior shareholder approval. Existing shareholders retain a 30-day right of first refusal (ROFR), but the procedural framework has been streamlined considerably.

Corporate governance and shareholder rights

Flexibility in governance structures

Companies may now adopt simplified governance models, including the elimination of supervisory boards in favour of audit committees. PE/VC investors should revise shareholder agreements to reflect this enhanced governance autonomy.

Enhanced minority protections

The legislation introduces new mechanisms enabling minority shareholders to challenge potentially abusive majority decisions, such as inequitable capital increases or dividend policies. PE/VC investors should leverage these provisions to safeguard their interests against founder dominance.

Procedural hurdles in redemption execution

Capital reduction requirements

For company-initiated redemptions, repurchases or buybacks of PE/VC investors' equity interests, mandatory capital reduction procedures now require unanimous shareholder approval, potentially complicating timely execution.

Creditor protections

Stringent creditor notification requirements during capital reduction processes may further delay repurchase transactions, creating potential conflicts with the statutory six-month completion deadline.

The 2024 Company Law represents a paradigm shift in China's corporate legal framework, emphasising enhanced creditor protection and increased shareholder accountability. For PE/VC investors, proactive adjustments to due diligence protocols, transaction terms and portfolio management strategies are essential to mitigate emerging risks and capitalise on new opportunities, particularly regarding class shares and streamlined exit mechanisms.

The Enforceability of Redemption Rights in China

Unlike in other jurisdictions, redemption rights in China's PE/VC investment transactions have emerged as a distinctive and contentious feature, reflecting the unique challenges and regulatory landscape of the domestic market. The following analysis examines their prevalence, implications and recent judicial developments.

Market characteristics and structural features

High prevalence and distinctive design

Approximately 90% of Chinese PE/VC transactions incorporate redemption rights, with a substantial proportion (up to two thirds) imposing joint and personal liability on founders through *"put option"* mechanisms. This contrasts markedly with US practice, where redemption rights primarily address liquidity concerns without imposing personal liability. Chinese redemption provisions typically require founders to personally repurchase investments with interest when companies fail to meet specified IPO or valuation thresholds that trigger investors' enforcement rights.

Severe consequences for founders

The enforcement of redemption rights has precipitated a significant increase in litigation against founders, with over 90% of cases naming both the portfolio company and individual entrepreneurs as defendants. Many founders subsequently face asset preservation orders, travel restrictions and inclusion in China's national credit blacklist system, effectively precluding them from future entrepreneurial endeavours.

Market drivers and systemic pressures

IPO constraints and exit challenges

The periodic suspension of domestic IPO approvals and increasingly stringent regulatory scrutiny has left numerous start-ups without viable exit pathways, compelling investors to rely more heavily on contractual redemption mechanisms.

Capital reallocation and policy imperatives

With foreign investment declining substantially and increasing State influence over domestic fund allocation, PE/VC investors face mounting pressure to prioritise policy-aligned returns, often to the detriment of founders.

Legal framework deficiencies

The absence of comprehensive personal bankruptcy legislation in China exacerbates risks for founders, who cannot discharge investment-related liabilities through bankruptcy proceedings.

Recent judicial developments

In December 2025, a Justice of the Supreme People's Court articulated that redemption rights or put options in PE/VC agreements must be exercised within six months following the occur-

rence of triggering conditions (such as failure to achieve an IPO or specified financial targets). Where no specific timeframe is contractually defined, the *"reasonable period"* defaults to six months; exceeding this period results in the extinguishment of the right. This interpretation aligns with earlier judicial guidance, including the 2024 Supreme Court directive that emphasised stabilising commercial expectations and preventing indefinite liability for repurchase obligors.

Key aspects of the judicial interpretation

Bifurcated rights framework

Redemption rights are characterised as comprising both *"formation right"* and *"claim right"*. The six-month limitation governs the initial formation phase (to trigger the repurchase obligation), after which the standard three-year statute of limitations applies for enforcing payment obligations.

Contractual autonomy parameters

Parties retain the prerogative to negotiate alternative timeframes, but courts may invalidate excessively protracted terms (eg, exceeding three years) as *"unreasonable"* under contract law principles.

Implied waiver doctrine

Failure to exercise rights within the prescribed timeframe constitutes an implied waiver, precluding subsequent claims.

Impact on China's PE/VC industry

Revised contractual practices

PE/VC firms must now explicitly define repurchase timelines in investment agreements to avoid defaulting to the six-month judicial standard. This necessitates precise specification of trigger dates (eg, post-IPO failure) and procedural requirements (eg, formal notification protocols). Ambiguous provisions (eg, references to *"reasonable period"*) may engender disputes, as courts increasingly prioritise textual clarity over contextual interpretation.

Accelerated exit strategies

Investors face heightened pressure to act expeditiously upon the occurrence of triggering events, as procedural delays risk forfeiture of valuable redemption rights. This may incentivise more rapid negotiations or litigation initiation. Portfolio companies exhibiting suboptimal performance may experience accelerated exits through forced buybacks, potentially destabilising valuation metrics across market segments.

Litigation and enforcement complexities

Investors must meticulously document redemption demands (including timestamps and delivery confirmations) to avoid dismissal on procedural grounds. Judicial interpretation of the *"reasonable period"* standard may prove inconsistent in edge cases (eg, delayed discovery of triggering conditions), creating additional uncertainty.

This legal interpretation has ignited significant controversy within the investment community. Proponents argue that it enhances corporate stability by implementing a decisive *"use it or lose it"* framework for repurchase rights, effectively eliminating prolonged uncertainty that could hamper business operations. However, critics contend that this stringent interpretation could have unintended consequences: investors, faced with the prospect of losing their protective rights, might prematurely trigger their repurchase options out of an abundance of caution. Such defensive actions could precipitate a cascade of early redemptions, potentially undermining the company's financial stability and operational viability. The tension between providing clear legal boundaries and maintaining flexible investor protections remains at the

heart of this ongoing debate. That said, these judicial pronouncements underscore the courts' commitment to balancing investor protection with commercial predictability, though their relatively rigid temporal limitations may strain PE/VC operational frameworks. Investment firms must adapt their practices expeditiously to preserve contractually negotiated rights.

Future prospects

While the Chinese government has indicated potential reforms, including *"tolerance policies"* for State-backed investors, the current investment environment remains challenging. The proliferation of redemption rights has effectively transformed PE/VC funding mechanisms to approximate debt financing structures, intensifying pressure on start-ups and potentially inhibiting innovation across the ecosystem.

In conclusion, redemption rights in Chinese PE/VC transactions reflect a complex interplay of liquidity protection mechanisms, regulatory imperatives and market uncertainty. However, their stringent enforcement has generated substantial risks for entrepreneurs and disrupted the equilibrium of the start-up ecosystem.

Conclusion

In 2024, China's PE sector navigated an increasingly complex landscape characterised by regulatory tightening, renminbi fund maturation, and cross-border innovation challenges. Legal practitioners assumed a pivotal role in interpreting evolving regulatory frameworks, structuring compliant transactions and implementing effective risk mitigation strategies. As the government continues to balance market vitality with systemic stability, the industry's capacity to adapt to nuanced regulatory developments will remain critical to sustaining growth and investment momentum.

DENMARK

Law and Practice

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Moalem Weitemeyer is a leading corporate M&A law firm in Denmark and the Nordics, known for providing exceptional legal advice and maintaining an uncompromising commitment to client availability. M&A is at the core of the firm's business. Moalem Weitemeyer's attorneys advise on the most complex and high-profile transactions in Scandinavia, covering all aspects of corporate and securities law. The firm also has a top-tier disputes practice, combining technical expertise with commercial awareness to consistently deliver outstanding results, both in and out of court. Moalem Weitemeyer maintains close and well-developed relationships with leading law firms across key jurisdictions – including Scandinavia, Germany, the UK and Asia, as well as top firms on Wall Street and in Palo Alto – ensuring seamless cross-border legal support.

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1. Trends

1.1 VC Market

Notable transactions related to venture capital (VC) during the past 12 months include the following.

- Flatpay, founded in 2022 by serial founders Sander Janca-Jensen, Rasmus Busk, Rasmus Hellmund Carlsen and Peter Lüth, is a Danish payment solutions provider for SMEs. Flatpay raised EUR45 million in a Series B funding round led by Dawn Capital, with participation from existing investor Seed Capital and other investors.
- Adcendo, a biotech company focused on the development of first-in-class ADCs for the treatment of cancers, closed an oversubscribed EUR128 million Series B financing round led by TCGX.
- Orbis Medicines, a Denmark-based company involved in oral macrocycle drug discovery, announced the close of a EUR90 million Series A funding round led by New Enterprise Associated, bringing the total amount raised by the company to EUR116 million.

1.2 Key Trends

Over the past 12 months, the Danish VC market has adapted to global economic uncertainty, leading to several key trends.

Investment selectivity has intensified, with VCs prioritising start-ups that demonstrate clear paths to profitability and proven business models, particularly in sectors such as cleantech, health tech and AI. Downrounds have become more common as valuations adjust, and there is an increased emphasis on profitability and cash flow rather than rapid growth. Due diligence processes have also become more rigorous, extending negotiation timelines.

Deal terms have evolved, in response to the subdued global VC market. Valuations are more conservative, resulting in lower dilution for founders, while convertible notes are being used more frequently to provide flexibility. Investors are also incorporating milestone-based funding structures to ensure that capital is deployed efficiently. Exit provisions, including stronger liquidation preferences, have gained importance, and VCs are securing greater governance rights, such as board seats or observer rights, to maintain oversight.

Additionally, ESG considerations remain a significant factor in investment decisions, with a growing focus on sustainability, particularly in clean energy and the circular economy.

Overall, while the Danish VC market mirrors global trends of increased caution, it remains resilient, emphasising sustainable growth, profitability and clear value propositions in an increasingly selective funding environment.

1.3 Key Industries

Between February 2024 and February 2025, Denmark's VC activity was primarily driven by the technology, life sciences and renewable energy sectors. The technology sector – particularly fintech and enterprise software – attracted substantial investment, reflecting increasing digitalisation and financial innovation.

Life sciences, with a strong focus on biotechnology and health tech, continued to benefit from Denmark's position as a hub for medical research and innovation. According to the Export and Investment Fund of Denmark, more than 60% of total Danish VC in 2023 was invested in the life sciences sector. Meanwhile, the renewable energy sector – especially wind energy and cleantech – experienced heightened VC interest,

aligning with the country's commitment to sustainability and green transition initiatives.

A distinction can be made between industries that experienced VC-backed exits and those that saw an increase in financing rounds. The technology sector, particularly fintech and software companies, accounted for a higher share of VC-backed exits, predominantly through M&A. In contrast, deep tech and renewable energy start-ups underwent multiple financing rounds, reflecting their capital-intensive nature and extended development timelines. This trend was further reinforced by the European Investment Fund's commitment to PSV Hafnium, Denmark's first venture fund dedicated to deep tech, underscoring the sector's need for sustained funding.

Overall, Denmark's VC landscape over the past year has followed a clear pattern: technology firms are more likely to achieve VC-backed exits, whereas deep tech and renewable energy companies continue to attract successive funding rounds to support long-term growth and commercialisation.

2. Venture Capital Funds

2.1 Fund Structure

In Denmark, VC funds are typically structured as limited partnerships (*Kommanditselskab* – K/S), where the general partner (GP) manages the fund, and limited partners (LPs) provide capital while maintaining limited liability. The GP is usually a private limited company (ApS or A/S) to minimise liability exposure.

Decision-making is governed by the limited partnership agreement (LPA), which defines capital commitments, governance and profit distribution. The GP has discretionary authority over investment decisions, often with oversight from an investment committee, which may include LP representatives.

Market-standard corporate documentation includes:

- an LPA – defines fund structure, governance, investor rights and capital calls;
- subscription agreements – regulate capital commitments and LP obligations;
- an Investment Committee Charter – establishes decision-making authority on investments;
- management agreements – outline roles, fees and responsibilities of fund managers; and
- side letters – address specific investor rights and bespoke terms.

2.2 Fund Economics

Fund principals typically participate in the economics of the fund through:

- management fees – usually ranging from 1.5% to 2.5% of committed capital, covering operational expenses; and
- carry or carried interest – standard market practice sets this at 20%, contingent on surpassing a predetermined hurdle rate (often 8%).

2.3 Fund Regulation

Danish VC funds are subject to the Alternative Investment Fund Managers Directive (AIFMD) and must comply with licensing, reporting and investor protection requirements. However, VC funds operating exclusively for professional investors may benefit from lighter regulatory obligations.

Funds structured as limited partnerships are not subject to direct corporate taxation, as profits and losses pass through to investors. Addition-

ally, certain government-backed VC initiatives may have extra reporting obligations.

2.4 Particularities

Denmark's VC ecosystem comprises a diverse mix of impact funds, fund-of-funds and government-backed VC initiatives. The Export and Investment Fund of Denmark (EIFO) and the European Investment Fund (EIF) play significant roles in supporting early-stage investments, often co-investing alongside private funds.

Given the extended holding periods in VC, fund strategies have adapted to accommodate this trend, including through:

- secondary market transactions – enabling LPs to exit positions before fund maturity;
- continuation funds – providing extended capital support to late-stage portfolio companies; and
- hybrid fund structures – combining VC with growth equity strategies.

3. Investments in Venture Capital Portfolio Companies

3.1 Due Diligence

VC fund investors in Denmark generally adopt a risk-weighted approach to due diligence, focusing their in-depth analysis on business-critical areas while addressing other customary topics through management discussions and targeted confirmatory inquiries. The level of scrutiny varies based on factors such as the company's industry, growth stage and regulatory exposure, ensuring a due diligence process that is proportionate to the associated risks.

Key areas of focus typically include ownership structure, intellectual property (IP) rights, key commercial contracts, and employment terms for key personnel. Investors assess the company's shareholding and capital structure, including any warrants, stock options or convertible instruments that could impact dilution and governance.

IP ownership and protections are particularly crucial for tech-driven companies, ensuring that patents, trade marks and proprietary technology are properly assigned to the company and are free from third-party claims. Likewise, a review of material commercial agreements helps evaluate long-term revenue stability, dependencies on key customers or suppliers, and contractual risks. On the employment side, investors typically scrutinise non-compete, non-solicitation, confidentiality and IP assignment clauses to ensure that founders, key employees and technical talent remain committed and aligned with the company's growth.

3.2 Process

The timeline for a new financing round in a growth-stage company with new anchor investors can vary significantly based on transaction complexity, the number of stakeholders involved, and due diligence requirements. Generally, the process takes between two and six months, covering key phases such as preparatory work, investor negotiations, due diligence, legal documentation and closing. The introduction of a new anchor investor often adds complexity, as they may require extensive due diligence, negotiate key terms and influence the investment round's structure.

A single financing round involves multiple parties with differing interests, including existing investors, new investors, the company, and sometimes key management. Existing investors typically aim to protect their pro rata rights, maintain

governance influence and secure exit pathways, while new investors – particularly anchor investors – often push for preferred terms, board representation or enhanced protections. Balancing these interests requires careful structuring of the investment agreements.

The choice of legal counsel depends on transaction dynamics. In some cases, all investors engage joint counsel to streamline negotiations, particularly when their interests align. However, in more complex rounds – especially those involving significant governance changes or investor protections – existing and new investors may retain separate counsel to negotiate terms independently. The company typically appoints its own legal advisers to safeguard its interests.

Decision-making mechanisms in a financing round depend on shareholder agreements and company by-laws. Majority requirements are often sufficient to approve new financings, particularly when structured within an agreed framework. However, financings rarely proceed strictly in line with the mechanics contemplated in the shareholders' agreement, requiring amendments to complete the round. Shareholders' agreements often specify that amendments require a certain approval threshold, such as shareholders representing 90% of the equity.

3.3 Investment Structure

In Denmark, early-stage financings often involve alternative equity instruments beyond common stock, particularly when investors seek downside protection, preferential returns or greater influence over corporate governance. The most commonly used instruments include preferred shares and convertible notes, each offering distinct rights and features that align with market standards.

Preferred Shares

Preferred shares are the most common alternative to common stock in VC financings, typically offering liquidation preferences, ensuring that investors recover their investment – often at 1x their original contribution – before common shareholders receive any proceeds in an exit or liquidation. These shares frequently include anti-dilution protections, usually structured as a broad-based weighted average adjustment, though full ratchet provisions may be negotiated in investor-favourable deals.

Voting rights attached to preferred shares are often equivalent to those of common stock, but investors typically negotiate veto rights over key corporate decisions, such as the issuance of new shares, amendments to governing documents, and significant M&A transactions. Additionally, preferred shareholders often secure board representation or, at a minimum, observer rights to maintain influence over strategic decisions.

Convertible Notes

Convertible notes are widely used in early-stage financings, particularly when valuation uncertainty makes equity pricing challenging. These instruments typically include:

- a discount (10%–25%) to the next financing round;
- a valuation cap to protect investors from excessive dilution if the start-up raises capital at a high valuation; and
- an interest rate (typically 3%–8%), though interest is often accrued and converted into equity rather than paid in cash.

The maturity date usually triggers automatic conversion at the next qualifying round, though some notes grant investors the option to request repayment if conversion does not occur with-

in the agreed timeframe. Additionally, most favoured nation (MFN) clauses are often included to ensure that investors receive the most favourable terms granted to any subsequent investors.

3.4 Documentation

A financing round in a Danish growth company typically involves a structured set of key legal documents to ensure clarity on investment terms, governance rights and post-closing obligations. The core documentation generally includes:

- an investment agreement;
- a shareholders' agreement;
- updated corporate governance documents; and
- ancillary documents related to share issuance and regulatory compliance.

While Denmark does not have a fully standardised set of VC investment templates similar to the NVCA (USA) or BVCA (UK) models, market practice often aligns with internationally recognised VC standards, particularly in deals involving institutional investors.

Investment Agreement

The investment agreement is the central document that sets out the terms of the investment, purchase price, conditions precedent, and representations and warranties given by the company – and, in some cases, by founders. It also includes closing mechanics, specifying the process for share issuance and fund transfers. The agreement typically outlines investor protections, such as warranties on financials, IP ownership, and compliance, often subject to liability limitations and disclosure carve-outs.

Shareholders' Agreement

The shareholders' agreement governs the post-investment relationship among shareholders, defining corporate governance rights, share transfer restrictions, exit provisions and investor protections. Standard provisions include:

- tag-along and drag-along rights;
- rights of first refusal;
- anti-dilution protection; and
- consent requirements for key business decisions.

Institutional investors often negotiate for board representation and veto rights over certain strategic decisions.

Articles of Association

A financing round also requires corporate documentation, including amended articles of association (in Danish:*vedtægter*) to reflect new share classes or investor rights. If new preferred shares are issued, the articles will specify liquidation preferences, voting rights and dividend structures. Additionally, cap table updates and shareholder resolutions formalising the issuance of new shares are required.

Ancillary Documents and Regulatory Compliance

Additional documents typically include:

- investor rights agreements;
- regulatory filings to ensure compliance with Danish corporate law; and
- know-your-customer/anti-money laundering (KYC/AML) documentation, particularly for institutional investors subject to regulatory oversight.

Market Practice and Standardisation

While Denmark does not have a set of mandatory VC templates, market practice frequently draws inspiration from Nordic model documents and internationally recognised frameworks, particularly in deals involving cross-border investors. Legal counsel typically tailors agreements to align with Danish corporate law, local investor expectations and company-specific considerations.

3.5 Investor Safeguards

In Denmark, VC investors secure various protections in downside scenarios, such as liquidation, to prioritise their returns over founders, employees and other stakeholders. Liquidation preferences ensure that investors recover their capital – often with a predefined return – before distributions to common shareholders.

While non-participating preferences remain the market standard, recent conditions have led to a growing prevalence of participating preferences, which allow investors to reclaim their initial investment and then participate in the remaining proceeds.

Anti-dilution provisions are also common, with broad-based weighted average adjustments being the preferred mechanism to prevent ownership dilution in downrounds, typically excluding shares issued under employee incentive plans.

Additionally, investors usually secure pre-emption rights, allowing them to maintain their stake by subscribing to new equity issuances before external investors. Depending on the deal dynamics, investors may also receive *"super pre-emption"* and right-of-first-refusal rights, ensuring that only the investor and holders of preferential shares can exercise these rights.

3.6 Corporate Governance

In addition to exercising influence through their ownership rights by voting at the general meeting, a VC investor would typically secure additional rights in a shareholders' agreement to influence the management and affairs of the venture.

Board Representation and Decision-Making

VC investors often secure seats on the company's board of directors, allowing them to participate directly in strategic decision-making. Board representation ensures that investors can oversee management actions and contribute to the company's long-term direction.

Approval Rights (Reserved Matters)

Investors may require approval rights over certain major corporate decisions, ensuring that their interests are protected. These reserved matters typically include:

- amendments to the company's governing documents;
- issuing new shares or financial instruments;
- changes to the capital structure;
- modifications to business operations;
- taking on debt;
- mergers or demergers;
- acquisitions or disposals of assets;
- dividend distributions;
- signing significant contracts;
- making substantial investments; and
- appointing or removing key executives.

Information Rights

Investors customarily obtain information rights, granting access to financial statements, budgets and strategic plans. Regular reporting obligations and the right to inspect company records allow investors to monitor performance and

ensure that management aligns with agreed-upon objectives.

3.7 Contractual Protection

In a Danish start-up or growth company financing round, the representations and warranties typically cover the following areas:

- legal status and corporate power;
- no conflict;
- issued shares/equity instruments;
- financial statements and, in some cases, management accounts;
- position since the accounts date;
- real property and other assets;
- IP rights (IPR) and IT;
- GDPR compliance;
- material agreements;
- related party transactions;
- employees and pension;
- insurance;
- tax matters;
- regulatory compliance;
- no insolvency;
- litigation; and
- disclosed information.

According to Danish market standards, the maturity of the company influences the extent of representations and warranties – the more mature the company, the more extensive the warranties. Notably, similar to M&A transactions, the representation and warranty catalogue in Denmark is generally less extensive and comprehensive than in jurisdictions such as the USA.

Recourse and Founder Liability

In pre-seed and early seed rounds, it is customary for the founder team to bear personal liability, subject to a claim hierarchy where investors must:

- firstly, seek recourse against the company; and
- secondly, seek recourse against the founders' holding companies.

Additionally, founders' personal liability is typically capped at one year's net salary.

4. Government Inducements

4.1 Subsidy Programmes

In Denmark, several government and quasi-government initiatives are designed to incentivise equity financing in growth companies.

The EIFO provides capital through loans or equity investments to support companies' development plans. Additionally, the Danish Growth Fund invests in private funds, which in turn invest in companies, and also directly provides equity investments in start-ups with significant growth potential.

4.2 Tax Treatment

In Denmark, the tax treatment of VC investments generally follows standard corporate tax rules but includes key distinctions aimed at encouraging investment.

Participation Exemption for Corporate Investors

Corporate investors benefit from the participation exemption, which makes capital gains and dividends on qualifying shares tax-free.

Tax Incentives for Start-Ups

Start-ups can take advantage of R&D tax deductions and equity incentives under Section 7P, which allow for tax deferral on employee share schemes. These incentives support VC investment, innovation and talent attraction in early-

stage companies. The deduction rates for R&D expenses are set at:

- 108% in 2025;
- 114% in 2026;
- 116% in 2027; and
- 120% in 2028.

Tax-Free Dividends on Unlisted Portfolio Shares

Recent regulatory changes have abolished taxation on dividends from unlisted portfolio shares (where a company owns less than 10%). Previously, these dividends were subject to a 15.4% tax (calculated as 22% of 70%).

This change eliminates the disparity between capital gains and dividend taxation on such shares. As a result, companies receiving dividends from unlisted portfolio shares are no longer subject to the 15.4% tax, aligning dividend and capital gains taxation.

4.3 Government Endorsement

The Danish government has launched substantial initiatives to increase equity financing activity. In May 2024, the government introduced 41 new initiatives aimed at improving business framework conditions and fostering talent development. These initiatives are part of a broader strategy to enhance the investment climate and support start-ups and innovative companies.

5. Employment Incentives

5.1 General

In Denmark, the long-term commitment of founders and key employees is typically secured through the following.

- Vesting agreements – equity ownership is earned over time, ensuring alignment with the company's sustained success. If a founder leaves prematurely, vesting provisions may limit their ability to retain their full share allocation, protecting other stakeholders.
- Employee equity incentive plans (ESOPs) – many venture-backed companies implement ESOPs, allowing founders and key employees to acquire a greater stake in the company. These plans may be structured as stock options or share purchase schemes, with vesting tied to time-based schedules or performance milestones (KPIs).

5.2 Securities

To incentivise founders and employees, Danish companies typically use equity-based instruments such as warrants and stock options, granting rights to acquire shares in the future, contingent on specific conditions or timeframes.

Standard terms include:

- (reverse) vesting – rights are earned over a set period; and
- exercisability – defines when and how options/warrants can be exercised, usually aligning with an exit event.

Implementing these plans early ensures flexibility for future investors.

5.3 Taxation of Instruments

Denmark offers favourable tax treatment under Section 7P of the Danish Tax Assessment Act. If certain conditions are met (eg, compensation not exceeding 10%–20% of an employee's annual salary), taxation is deferred until the sale of shares, at which point gains are taxed as capital income (up to 50%). This provides a significant advantage over standard income taxation.

5.4 Implementation

When implementing an investment round, it is common to establish an employee incentive programme concurrently with a new investment round. This ensures that a portion of equity is allocated before new investments, managing dilution effects.

The size and structure of these programmes are key negotiation points in VC financings, and are typically documented in the investment agreement or shareholders' agreement. However, implementation is often delegated to the (new) board of directors post-closing, with minimal direct impact on the VC investment process itself.

6. Exits

6.1 Investor Exit Rights

VC shareholders' agreements in Denmark typically include exit provisions governing liquidity events such as trade sales or IPOs.

Common clauses include:

- tag-along rights – allow minority shareholders to sell under the same terms as majority shareholders; and
- drag-along rights – enable majority shareholders to force minority shareholders to sell on agreed terms.

Exit triggers are often tied to:

- achieving specific financial milestones;
- reaching a predetermined investment horizon; and
- receiving qualifying acquisition offers.

Transfer restrictions typically include:

- rights of first refusal – existing shareholders have the first option to purchase shares before external investors; and
- lock-in periods – restricting share sales within a set timeframe to ensure stability.

6.2 IPO Exits

The Danish initial public offering (IPO) market has fluctuated significantly. After a peak in 2021, activity slowed, with only three IPOs in 2023 and none in 2024. This has shifted investor preferences towards trade sales as a more reliable exit strategy.

Recent legislative changes allow companies to opt for realisation-based taxation for up to seven years after an IPO, meaning taxes are paid only upon the actual sale of shares, rather than on unrealised mark-to-market gains, which previously applied to companies holding less than 10% ownership in listed companies. This provides a liquidity advantage for founders and early investors, especially those subject to IPO lock-ups.

The realisation-based taxation option applies to IPOs taking place between 1 January 2015 and 31 December 2024, and is available to *"original shareholders"* defined as shareholders who have held shares in the company for at least 30 days prior to the IPO.

For past income years, shareholders may request a reopening of their tax return to claim a refund of previously paid tax, provided the company has an overall capital gain on the shares. Such requests must be submitted no later than 1 July 2025.

Going forward, investors in companies listed within the past seven years, as well as newly listed companies, will have the option to apply realisation-based taxation.

This change provides a significant liquidity advantage, as companies and investors are not required to pay tax on unrealised gains. As stated, it is particularly beneficial for founders and early investors, who are often subject to IPO lock-up periods, restricting their ability to sell shares immediately after listing.

6.3 Pre-IPO Liquidity

IPOs remain relatively uncommon for start-ups in Denmark, primarily due to stringent regulatory requirements and the high costs associated with public listings. When companies do pursue an IPO, they typically consider Nasdaq Copenhagen or other European exchanges, depending on company size, industry focus and investor interest. The timeline for an IPO is shaped by factors such as the company's growth trajectory, market conditions and regulatory preparedness.

Pre-IPO Liquidity Considerations

There is a growing recognition of the need for pre-IPO liquidity, enabling early investors and employees to realise returns before a formal exit event. However, creating a structured secondary market presents challenges, including:

- regulatory compliance;
- valuation complexities; and
- potential impacts on company control and confidentiality.

To navigate these challenges, company-facilitated tender offers can serve as a strategic solution. This approach allows the company to repurchase shares or facilitate sales to approved investors, providing liquidity while maintaining oversight and stability in the shareholder base.

7. Regulation

7.1 Securities Offerings

VC transactions in Denmark are primarily governed by the Danish Companies Act and the Danish Capital Markets Act, ensuring shareholder protection and market efficiency.

For larger transactions involving multiple investors or employees, compliance with the Danish Alternative Investment Fund Managers Act (the *"AIFM Act"*) may be required. Unlike some jurisdictions, Denmark does not provide a private placement exemption under AIFM rules, meaning prior regulatory approval is needed to market such funds.

Denmark maintains an open policy for foreign VC investments, though the Danish Investment Screening Act (DISA) requires pre-approval for investments in critical sectors such as:

- defence and IT security;
- critical infrastructure (eg, energy, telecoms); and
- financial agreements with national security implications.

7.2 Restrictions

Foreign VC investors generally face few restrictions in Denmark. However, the Danish foreign direct investment (FDI) screening framework has been increasingly enforced over the past year, particularly concerning Chinese and non-EU/EEA investors.

FDI approval is required for investments where non-EU/EEA investors acquire 10% or more of

voting rights in companies operating in sensitive sectors. Despite the increased scrutiny, only one investment has ever been prohibited by the Minister for Industry, Business and Financial Affairs.

Sector-Specific Regulations

Certain industries impose additional restrictions on foreign investors:

- financial institutions (eg, banks, payment service providers) require approval from the Danish Financial Supervisory Authority (*Finanstilsynet*); and
- energy and infrastructure – foreign ownership of critical infrastructure is subject to restrictions.

Trends and Developments

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Moalem Weitemeyer

Moalem Weitemeyer is a leading corporate M&A law firm in Denmark and the Nordics, known for providing exceptional legal advice and maintaining an uncompromising commitment to client availability. M&A is at the core of the firm's business. Moalem Weitemeyer's attorneys advise on the most complex and high-profile transactions in Scandinavia, covering all aspects of corporate and securities law. The firm also has a top-tier disputes practice, combining technical expertise with commercial awareness to consistently deliver outstanding results, both in and out of court. Moalem Weitemeyer maintains close and well-developed relationships with leading law firms across key jurisdictions – including Scandinavia, Germany, the UK and Asia, as well as top firms on Wall Street and in Palo Alto – ensuring seamless cross-border legal support.

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Introduction

Denmark's venture capital (VC) ecosystem demonstrated resilience and growth in 2024, driven by legislative reforms, increased investment activity, and a focus on technology and innovation. The market saw fluctuations in investment volumes, with a strong first half followed by a downturn in Q3. The AI and fintech sectors led the way, while green VC reached record levels. Government initiatives and regulatory changes further strengthened Denmark's position as an attractive investment hub, despite global economic uncertainties.

Strong Start With Increased Investment Rounds

In the first quarter of 2024, the Danish venture market experienced a rise in the number of investments but a decline in the total amount invested. Approximately DKK1.8 billion (EUR241 million) was invested across 36 investment rounds. This represents a 24% increase in the number of investments compared to the fourth quarter of 2023, but a 21% decrease in the total amount invested. The average amount invested per round fell by approximately 35%, reflecting a higher proportion of investments in the earlier venture stages.

A significant driver of activity in Q1 was the DKK600 million (EUR80 million) investment in the mobility company Monta, which accounted for one third of the total amount invested. Other major investments included Lunar (fintech), Formalize (SaaS/enterprise solutions) and Orbis Medicines (biotech), which collectively raised DKK400 million (EUR53 million). These investments highlight the continued interest in fintech, SaaS solutions and biotechnology.

AI Sector Sees Rapid Expansion

In the first quarter of 2024, the AI sector in Denmark experienced a significant surge in investment activity, reaching a historic high. AI-based companies attracted a total of DKK150 million (EUR20 million) across six investment rounds, comprising 17% of all investment rounds in the Danish VC market during this period. This notable increase underscores the growing importance and potential of AI in driving innovation and economic growth.

The largest investment in the AI sector during Q1 2024 was DKK72 million (EUR10 million) in Go Autonomous, a company specialising in SaaS/platform software. This substantial investment reflects the increasing demand for AI-driven solutions that enhance efficiency, automation and decision-making processes across industries. Go Autonomous's focus on developing advanced AI technologies positions it as a key player in the evolving AI landscape.

Despite the significant capital directed towards AI-based companies, the majority of these investments were skewed towards early-stage rounds. This trend reflects the nascent stage of many AI start-ups, which are still in the process of developing and refining their technologies. As a result, the total share of Danish VC allocated to AI companies was relatively lower compared to other sectors. However, the focus on early-stage investments signals strong belief in the long-term potential of AI technologies and their ability to disrupt traditional business models.

In the second quarter of 2024, the Danish venture market recorded total investments of DKK2.6 billion (EUR349 million) across 30 rounds. This represents a 26% increase in total investment compared to Q1, despite a 19% decline in the number of deals. The average investment size

rose by nearly 55%, signalling a preference for later-stage investments requiring larger capital infusions.

AI investments in Q2 reached DKK511 million (EUR68 million) across seven rounds. The largest AI investments were in GetWhy, which raised DKK237 million (EUR32 million), and Reshape Biotech, which secured DKK139 million (EUR169 million), together comprising over 70% of total AI capital. AI accounted for 14% of total VC and 19% of Q2's investment rounds, demonstrating growing confidence in AI applications across a range of industries.

Fintech

In the second quarter of 2024, the fintech sector emerged as the dominant force in the Danish VC market, attracting a substantial DKK1.3 billion (EUR175 million) across six investment rounds. This significant influx of capital underscores the growing importance and influence of fintech in the broader financial services landscape. Two major investments were pivotal in driving the sector's dominance during this period.

- Ageras, a company specialising in financial services and accounting solutions, secured a remarkable DKK612 million (EUR82 million). This investment highlights the increasing demand for innovative financial management tools and services that streamline business operations and enhance financial transparency.
- Flatpay, a company focused on providing automated payment solutions, raised DKK335 million (EUR45 million), reflecting the rising need for efficient and secure payment processing systems in the digital economy.

These two investments alone accounted for a substantial portion of the total VC directed towards fintech, comprising 37% of the total VC investment in Q2 2024. Fintech's dominance is further emphasised by its share of total VC in the quarter.

The sector accounted for 50% of all VC investments during this period, highlighting its critical role in driving financial services innovation. This significant share indicates strong investor confidence in the potential of fintech companies to revolutionise traditional banking and financial services through digital banking solutions, automated payment systems and other technological advancements.

The substantial investments in fintech during Q2 2024 reflect the sector's increasing role in financial services innovation. Companies such as Ageras and Flatpay are at the forefront of developing solutions that enhance the efficiency, security and accessibility of financial services.

Digital banking platforms are becoming more prevalent, offering consumers and businesses convenient and user-friendly alternatives to traditional banking methods. Automated payment solutions are also gaining traction, providing faster and more secure transaction processing – an essential feature in the rapidly evolving digital economy.

The dominance of the fintech sector in Q2 2024, marked by significant investments in companies such as Ageras and Flatpay, underscores the sector's pivotal role in shaping the future of financial services. With fintech accounting for 50% of all VC investments during this period, it is clear that the sector is driving substantial innovation in digital banking, financial management and automated payment solutions.

Q3 Slowdown Despite Stable Deal Count

In the third quarter of 2024, the Danish VC market experienced a significant downturn, with total invested capital amounting to DKK1.2 billion (EUR161 million), representing a 50% decline compared to the DKK2.6 billion (EUR348 million) invested in the second quarter. Despite this sharp decrease in capital, the number of investment rounds remained steady at approximately 30. The average investment size decreased by nearly 50%, indicating a higher proportion of bridge rounds and a notable reduction in late-stage and growth-stage funding, which fell by more than 50%.

The primary investment drivers in Q3 2024 were life science companies Again and Cerebriu, and cleantech company Stiesdal. These three companies collectively raised over 40% of the total invested capital. Specifically, Again secured DKK223 million (EUR30 million), Cerebriu raised DKK126 million (EUR17million) and Stiesdal obtained DKK201 million (EUR27 million).

These significant investments highlight the continued interest in and support for the life sciences and cleantech sectors within the Danish VC market. The life sciences sector, with companies such as Again and Cerebriu, attracted substantial investment due to the growing demand for advanced medical technologies and treatments. The cleantech sector, represented by Stiesdal, also received considerable investment, reflecting the ongoing commitment to sustainable and environmentally friendly technologies.

Strong Rebound in Danish VC Investments – Q4 2024 Marks a Return to Growth

The Danish VC market experienced a notable recovery in the fourth quarter of 2024, with investment levels increasing significantly compared to the previous quarter. Total investments reached DKK2.7 billion (EUR364 million) across 31 financing rounds, largely propelled by a few high-value transactions, including Adcendo (biotech), Antag Therapeutics (biotech) and Keepit (enterprise solutions). These three deals alone accounted for over DKK1.8 billion (EUR250 million) of the total deployed capital.

While quarter-on-quarter fluctuations in venture funding are common, the sharp 111% increase in Q4 followed a subdued Q3, signalling a return to more typical investment activity rather than an outright acceleration. Deal volume expanded by a moderate 7%, and investment levels remained approximately 20% above those recorded in Q4 2023.

Denmark's performance stood out in a global context. While investment volumes increased across key international markets, the number of deals declined in the United States, Europe and globally. Denmark, in contrast, experienced simultaneous growth in both capital deployment and transaction count, demonstrating relative resilience in an otherwise uncertain economic climate.

Green VC Investments

Green VC investments in Denmark reached a record high in the first three quarters of 2024, surpassing the previous record set in 2022. The total amount of VC allocated to green businesses was DKK1.7 billion (EUR228 million), representing a 26% increase compared to 2023. The number of investment rounds for green ventures reached 85% of last year's total. Consequently, the share of Danish VC investments directed towards green companies increased, accounting for 29% of invested capital and 26% of investment rounds – up from 16% and 24%, respectively, in 2023. This growth reflects the increasing importance of and focus on sustainable and

environmentally friendly business models within the Danish VC market.

In the fourth quarter of 2024, the Danish green technology sector experienced a significant boost, with VC investments reaching record levels. The total investment volume in green tech companies amounted to DKK2 billion (EUR266 million) across 32 funding rounds, marking a 40% increase in investment volumes and a 10% rise in deal count compared to the previous year. This growth reflects the sector's continued expansion, driven by an increasing investor focus on sustainability.

Despite the strong investment momentum, the sector faces challenges due to rising capital costs and long commercialisation timelines, which make scaling green technologies more difficult. Additionally, high-profile failures of venture-backed companies have heightened investor caution, leading to a more selective approach to green investments. As a result, while the sector shows promising growth, uncertainty around future investment levels remains due to macroeconomic pressures and shifting investor priorities.

Exit Opportunities

Danish IPO activity has seen a notable decline in recent years. After peaking in 2021 with a record high of 26 IPOs, the number of listings dropped significantly, with only three companies listed in 2023. This downward trend continued into 2024, with no IPOs completed in the first half of the year.

The decline forms part of a broader trend across Nordic markets, driven by increased stock market volatility and reduced investor confidence, making the environment less favourable for IPOs. Despite the Danish stock market performing well in the first half of 2024, companies have been hesitant to pursue listings, partly due to continued investor caution and a preference for low-risk alternatives such as government bonds.

Matchloans

Matchloans, offered by the Export and Investment Fund of Denmark (EIFO), are a financial instrument designed to support early-stage start-ups in Denmark by matching investments from private investors on a one-to-one basis. This means that, for every krone invested by a private investor, EIFO provides an additional krone, effectively doubling the capital available to the start-up.

The loans range from a minimum of DKK500,000 to a maximum of DKK3 million, and are structured with a six-year term, including an initial three-year interest-only period. Matchloans are particularly attractive to companies as they provide substantial funding without diluting the founders' equity, thereby preserving their control and ownership.

Additionally, these loans enable start-ups to leverage private investments, share risk with investors, and establish a solid financial foundation to scale their businesses. The structured support from EIFO, combined with the expertise and networks of private investors, enhances the potential for start-ups to achieve their growth and innovation objectives.

Foreign Direct Investment (FDI) Screening

Over the past year, enforcement of Denmark's FDI screening framework has intensified, with authorities conducting more in-depth reviews – particularly for investments linked to Chinese or non-EU/EEA investors. Despite this heightened scrutiny, only one case to date has resulted in the Minister for Industry, Business and Financial

Affairs blocking an investment. The investment was subsequently approved.

Policy Reforms Improving the Investment Climate

Legislative reforms have played a crucial role in shaping Denmark's VC market. Amendments to the Danish Companies Act, effective from 1 January 2025, have simplified capital-raising for private limited companies (in Danish:*anpartsselskab*), allowing them to offer shares to the public under certain conditions. This change, previously limited to public limited companies (in Danish:*aktiesselskab*), has created new financing opportunities for start-ups.

Additionally, the minimum capital requirement for private limited companies was reduced from DKK40,000 to DKK20,000 as of 27 February 2025, thereby lowering entry barriers for entrepreneurs. The approval of equity crowdfunding platforms has further diversified the sources of investment, broadening access to capital for early-stage businesses.

The new Danish legislation thereby enhances access to financing for Danish limited liability companies by allowing them to offer equity shares to the public through equity crowdfunding. For companies operating within the venture market, this provides an opportunity to reach a broader pool of investors.

Government Initiatives Fuelling Growth

One of the most impactful government measures supporting the growth of the Danish VC market is the elimination of dividend taxes on unlisted shares, introduced in July 2024. This policy has made investments in start-ups and early-stage companies significantly more attractive to investors. By removing the tax burden on dividends from unlisted shares, the Danish government has incentivised early-stage funding, providing start-ups with the critical growth capital they need to scale their operations and innovate. This measure not only enhances potential returns for investors but also fosters a more dynamic and supportive investment environment for emerging companies.

In alignment with Denmark's sustainability agenda, the government has allocated DKK2 billion to EIFO, specifically to boost green technology investments. This substantial funding underscores the government's commitment to fostering environmental innovation and supporting the development of green technologies.

By channelling significant financial resources into the green sector, the Danish government aims to strengthen the country's position as a leader in environmental innovation. This initiative not only attracts VC to green start-ups but also promotes the development of sustainable solutions that address global environmental challenges.

Challenges and Future Outlook

One of the primary challenges facing the Danish VC market is global economic uncertainty and market volatility, both of which significantly affect investor confidence and the availability of funding. Economic fluctuations and geopolitical tensions can lead to more cautious investment behaviour, reducing the flow of capital into the venture market. This uncertainty makes it more difficult for start-ups to secure the funding needed to scale operations and innovate.

Another challenge is the intense competition for top talent and resources among start-ups. As the number of start-ups increases, so too does the demand for skilled professionals, particularly in specialised fields such as technology and life

sciences. Additionally, the limited availability of resources – such as office space and advanced research facilities – can further strain the growth potential of emerging companies.

Despite these challenges, Denmark's emphasis on health tech and green innovation provides a robust foundation for sustained growth in the VC market. With the implementation of several government initiatives and policy reforms aimed at fostering innovation and supporting start-ups in these sectors, the future appears bright.

Health tech, in particular, has seen significant investment activity, with companies such as Again and Cerebriu raising substantial capital in recent quarters. These investments reflect the growing demand for innovative healthcare solutions that can improve patient outcomes and reduce healthcare costs. Denmark's strong healthcare infrastructure and the collaborative ecosystem between academia, industry and government create an ideal environment for health tech start-ups to thrive.

Similarly, green innovation has gained considerable traction, with green VC investments reaching record highs. In the first three quarters of 2024, green businesses in Denmark attracted DKK1.7 billion in VC – a 26% increase compared to the previous year. This growth is driven by the global shift towards sustainability and the increasing importance of environmentally friendly business models. Danish companies such as Stiesdal, which focus on cleantech solutions, are at the forefront of this movement, attracting significant investment and reinforcing Denmark's reputation as a leader in green innovation.

Conclusion

The Danish VC market's experience in 2024 served as a microcosm of the broader challenges faced by start-ups and investors during periods of economic and geopolitical uncertainty. The significant decline in invested capital – despite a stable number of investment rounds – highlights the cautious approach adopted by investors under such conditions.

For start-ups, this environment can be particularly challenging. Securing funding becomes more difficult as investors grow increasingly risk-averse, preferring to allocate capital to safer, more established ventures or sectors perceived as more resilient. This can stifle innovation and growth, as early-stage companies struggle to access the financial support required to develop products, scale operations and bring new technologies to market. Initiatives such as Matchloans have played a valuable role in strengthening early-stage start-ups by providing crucial non-dilutive funding and bridging the gap in an otherwise risk-averse investment climate.

However, the continued investment in the life sciences and cleantech sectors during Q3 2024 demonstrates that even in uncertain times there are areas of the market capable of attracting significant capital. These sectors are often viewed as having strong long-term growth potential and the capacity to address critical global challenges, such as healthcare advancements and environmental sustainability. Investors may consider these sectors more resilient to economic fluctuations and geopolitical tensions, making them attractive options for capital allocation.

At the same time, the decline in exit opportunities – particularly through IPOs – has made it more difficult for investors to realise returns, resulting in a growing reliance on M&A activity and secondary sales. Additionally, increased FDI screening has introduced further regulatory complexity for foreign investors, especially those

from non-EU/EEA countries, potentially impacting the inflow of international VC.

The Danish government's proactive measures, such as the elimination of dividend taxes on unlisted shares and the allocation of substantial funds to green technology investments, continue to play a crucial role in supporting the VC market. These initiatives help foster a more favourable investment climate, encouraging both domestic and international investors to fund innovative start-ups. By reducing bureaucratic hurdles and introducing targeted tax incentives, the government further enhances Denmark's attractiveness as a destination for VC.

In Q4 2024, the Danish VC market showed strong signs of recovery, with a notable increase in both investment levels and deal volume. This growth, largely driven by a few large transactions, underscores that despite broader challenges Denmark remains a resilient and attractive market for investors.

In conclusion, while economic fluctuations and geopolitical tensions posed significant challenges to the VC market in 2024, the strong rebound in Q4 – combined with a strategic focus on resilient sectors and supportive government policies – helped mitigate these impacts. By continuing to support high-potential industries and maintaining a conducive investment environment, Denmark is well positioned to sustain its leadership in innovation and VC, driving long-term growth and technological advancement.

EGYPT

Law and Practice

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Zaki Hashem, Attorneys at Law is Egypt's oldest and largest law firm, founded in 1953, and offers the full spectrum of corporate legal services with a team of over 100 fee earners, fluent in Arabic, English, French, German and Italian. The team also includes dual-qualified lawyers with experience from top international firms who are able to advise investors on the most efficient vehicles and structures for undertaking their investments. Reinforced, also, by solid connections at all relevant government authorities in Egypt, Zaki Hashem, Attorneys at Law combines deep local market expertise with a strong legal and business vision, offering its clients innovative solutions and high-quality real-time legal counsel.

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1. Trends

1.1 VC Market

Over the past 12 months, Egypt's venture capital (VC) landscape has continued to show resilience and adaptability, even amid global investment slowdowns and local economic challenges. One of the defining features of the current market structure is that acquisitions and capital injections often take place at the level of offshore Special Purpose Vehicles (SPVs), which are set up by the founders of Egyptian operating companies. This particular structure reflects the preference among investors for familiar legal frameworks and currency flexibility.

Additionally, while the traditional classification of funding rounds (Series A, B and beyond) remains part of the local investment language, their conventional definitions – widely recognised in more mature VC ecosystems – have become less indicative in the Egyptian market. This shift is primarily attributed to modifications in local investment practices, influenced significantly by recent currency devaluations. Consequently, these traditional classifications may not accurately represent a company's actual stage of development or funding structure as they typically do in more developed VC environments.

Nevertheless, the market has seen substantial VC activity, particularly in more mature and growth-stage companies. These transactions demonstrate sustained interest from investors in Egypt's innovation-driven sectors and highlight the potential of Egyptian startups to scale regionally and attract strategic capital.

In the past year, notable VC transactions in Egypt have included the following.

- In May 2025, Nawy, an Egyptian proptech startup, raised USD52 million in a Series A equity funding round led by Partech Africa, with participation from other investors. Nawy also secured USD23 million in debt financing from Egyptian banks and financial institutions.
- Also in May, MoneyFellows, an Egyptian fintech startup, raised USD13 million in a pre-Series C round led by Al Mada Ventures and DPI Venture Capital via the Nclude Fund, with the participation of other investors.
- USD16 million secured by Khazna in a pre-Series B funding round in February 2025. The round attracted investments from both new and existing backers, including global firms such as Quona and Speedinvest, as well as regional investors such as Aljazira Capital, anb Seed Fund, DisrupTech Ventures, ICU

Ventures, Khwarizmi Ventures, and SANAD Fund for MSME.
- Also in February, UAE-based tech giant Dubizzle Group successfully acquired Hatla2ee, one of Egypt's leading online car marketplaces for an undisclosed amount.
- In July 2024, a substantial funding round for fintech leader MNT-Halan successfully raised around USD157 million from International Finance Corporation (IFC), DPI (Development Partners International), Lorax Capital Partners, and funds managed by Apis Partners LLP, Lunate and GB Corp.
- In April 2024, Cairo-based fintech startup Bokra raised USD4.6 million in a pre-seed funding round led by DisrupTech Ventures and SS Capital, among other investors.
- In January 2024, Health-tech startup Yodawy secured USD10 million from Ezdehar's Mid-Cap Fund II.
- In her speech at the Egypt's Venture Investment Summit 2025, Minister of Planning, Economic Development and International Cooperation H.E. Dr Rania El Mashat stated that startups in Egypt have raised approximately USD2 billion in VC funding over the last five years. She also indicated that Egypt ranks third in Africa and the Middle East in terms of VC funding and deal execution.

1.2 Key Trends

Egypt has seen relatively larger transaction sizes concentrated among more mature companies in recent years. As stated in **1.1 VC Market**, a key structural trend is the increasing use of offshore SPVs to facilitate 100% ownership of operating companies in Egypt – motivated by investor familiarity with international legal standards and ease of repatriation. This has prompted government initiatives such as the Ministerial Group for Entrepreneurship, established by Decree No 2878 of 2024 issued by the Prime Minister. The group is led by H.E. Dr Rania El Mashat, Minister of Planning, Economic Development and International Cooperation, to encourage direct investment structures within Egypt. Investors now prefer later-stage companies with proven financial health and clear paths to profitability.

In general, key changes in investment terms include:

- reduced valuations, leading to more *"down-rounds"*;
- increased investor protections, such as liquidation preference and anti-dilution rights; and
- more frequent use of milestone-based financing structures.

In addition to the above, due diligence exercises have become increasingly meticulous, in particular in the fintech sector. Given the detailed laws and regulations surrounding technology requirements for fintech, investors are now conducting more comprehensive due diligence, including technical due diligence to ensure compliance and mitigate risks. This shift is also driven by recent challenging transactions, prompting a move away from high-level due diligence to more thorough assessments.

1.3 Key Industries

Fintech remains Egypt's leading sector for VC activity, drawing substantial funding due to its high growth potential. Health-tech, logistics, edtech and agriculture technology have also attracted increased investor interest. Biotech, in particular, is gaining traction as a strategic sector with high acquisition potential once products are market ready. In the current macroeconomic environment, startups that generate foreign currency revenues have become particularly appealing.

In addition to the above, globally, appetite for marketplace acquisitions has shown signs of moderating. Despite this, Egypt's VC landscape has seen noteworthy activity in the marketplace segment, with two acquisitions standing out.

In February 2025, UAE-based Dubizzle Group acquired Hatla2ee, Egypt's leading online automotive marketplace. Similarly, in late 2021, South Africa's SweepSouth acquired FilKhedma, a home services marketplace operating across major Egyptian cities. While two transactions alone may not necessarily establish a definitive trend, their significance in Egypt's VC landscape cannot be overlooked.

In terms of exit dynamics, based on general observation of the market, sectors such as logistics and fintech (e-payments) tend to offer clearer acquisition pathways and have seen more exits, while edtech, fintech (BNPL) and biotech continue to attract new funding rounds, reflecting long-term growth expectations – even if exit timelines may extend further into the future. While this perspective reflects practical market experience, more detailed research by financial analysts and sector-focused institutions could offer a deeper understanding of underlying trends and investment patterns.

2. Venture Capital Funds

2.1 Fund Structure

VC Activities Legal Forms

VC activities in Egypt have been regulated under Capital Market Law No 95 since 1992. Based on this law, companies conducting VC activities are classified as Companies Operating in the Field of Securities (COSF) and fall under the category of Non-Banking Financial Services (NBFS), supervised by the Financial Regulatory Authority (FRA). They must be established as Joint Stock Companies (JSCs) or Companies Limited by Shares (CLSs).

The law defines VC activities as providing financing, technical assistance, or participating in high-risk or underfunded projects, typically aiming to transform these projects into JSCs or CLSs. Companies wishing to conduct VC activities must obtain a licence from the FRA and be registered in the official VC Companies Register.

Over time, Egypt has introduced new structures to align with international fund models. In 2007, the closed-ended direct investment fund structure known as the Private Ownership Fund (POF) was introduced. This fund invests in listed and unlisted securities and can carry out VC activities. Despite being available for over a decade, to the best of our knowledge, only two such funds, Sawari Ventures Fund and Catalyst Fund, have been set up by the private sector.

In response to repeated demand among industry players for globally familiar structures, Ministerial Decree No. 113 of 2018, as amended (Decree 2018), authorised the use of CLSs for conducting private equity – and potentially VC – activities. The model resembles the international GP/LP structure, where the general partner (the GP) manages the fund and limited partners (the LPs) provide capital. While JSCs were added as an eligible legal form in 2022, no JSC has been licensed yet under this regime. To date, only a couple of GP/LPs – such as Avanz Capital – have received licences.

In addition to the above-mentioned formal venture capital structures regulated under the Capital Market Law, industry players may conduct VC activities through holding companies or ordinary companies established under Companies Law

No 159 of 1981, as amended (the Companies Law). From a legal standpoint, there are no restrictions preventing these entities from investing in other companies.

Holding companies are defined by the Capital Market Law as: *"companies (i) carrying out the activity of establishing or participating in companies undertaking NBFS activities; or (ii) have more than half of their investment portfolio consists of NBFS companies"*. As such, they are regulated by the Capital Market Law, its Executive Regulation and the regulations issued by the FRA in this regard.

Ordinary companies incorporated under the Companies Law can invest in companies and, at the same time, remain outside the umbrella of the Capital Market Law as long as they do not fall within the definition of holding companies.

Consequently, there is no effective mechanism to quantify the number of entities undertaking VC activities on a de facto basis.

Decision-Making Process

In foreign jurisdictions, VC fund governance typically centres around the GP, entrusted with broad authority to manage the fund in accordance with pre-agreed policies laid out in the limited partnership agreement. In return, the GP bears unlimited liability – although this can be mitigated contractually – for the fund's management.

Such straightforward delegation of authority has only been possible within Egypt's regulatory framework since recent reforms. Before Decree 2018 allowing CLSs to carry out VC activities, it was not legally possible to replicate the traditional GP model. Since most Egyptian VC structures were created as JSCs, decision-making powers were distributed across corporate bodies such as the Board of the Directors and the General Assembly of Shareholders.

To address this, in practice, VC companies could enter into tailored management agreements granting broader powers to an appointed manager – often mirroring the role of a GP – subject to appropriate corporate authorisations. While this workaround provides some flexibility, it does not reflect the structures commonly encountered by foreign investors in other jurisdictions with more mature VC fund regulations.

The corporate governance structure of a POF, or Private Ownership Fund, further illustrates the divergence from international VC models. A POF is governed by four main bodies: (i) the Board of Directors; (ii) the General Assembly of Founders; (iii) the Certificate Holders' Assembly; and (iv) the fund's Investment Manager. Each body has distinct powers, the rationale behind this being to contribute to a carefully balanced system of checks and responsibilities.

Documentation

In terms of documentation, POFs can only raise funds through an information memorandum (IM) to be approved by the FRA, a template of which is published by the latter. POFs are governed by their Articles of Association (AOA) and the IM, which must be updated annually. GP/LP structures as allowed under Decree 2018 also have a much simpler IM to be shared with the investors and the FRA (the template of which is annexed to Decree 2018), and, together with other VC structures, typically use AOA, Subscription Agreements (SSAs), Shareholders' Agreements (SHAs), and management agreements. The GP/LP's IM will determine the percentage and fields of the company's investments, the maximum limit of investment in a single company, the cir-

cumstances in which it is permissible to acquire majority stakes in one company, and the extent to which it is permissible to exceed the percentage of investment in one company at the beginning of the investment.

2.2 Fund Economics

VC structures in Egypt benefit from tax treatment that avoids double taxation, meaning that investment income is taxed only once, and not at the fund level and again at the level of the LPs. This approach is consistent with international best practices, and is considered a positive feature of the Egyptian regulatory framework.

Fund-manager compensation also aligns with international market norms, where managers typically earn an annual management fee (commonly 2% of committed capital) and carried interest (usually 20% of fund profits after capital has been returned and a hurdle rate met). A deal-by-deal distribution model tends to be preferred, usually coupled with contractual clawback arrangements.

That said, certain elements of the existing framework diverge from global fund structuring standards, and could have an impact on fund economics:

- *capital contribution mechanics* these do not currently mirror the international model of flexible capital calls, which may create practical challenges for fund managers who need to align capital inflows with the timing of investment opportunities; and
- *the profit distribution framework* the current regulatory framework does not incorporate the internationally recognised waterfall distribution model, nor does it provide for distribution in specie (ie, in-kind distribution of assets), which can be an important tool in maximising exit flexibility and investor returns.

As a result of these structural differences, GPs may be required to adopt contractual workarounds to deliver outcomes that align with the expectations of international LPs. While these arrangements can be effective in practice, they may create hesitation among some foreign investors who are more comfortable with familiar structures.

2.3 Fund Regulation

See **2.1 Fund Structure**. There are several options for carrying out VC activities, each with their own advantages and disadvantages, depending on manager and investor objectives and preferences. However, other than ordinary companies which, de facto, practice VC activities as explained in **2.1 Fund Structure**, all of these structures are regulated by the FRA. They must comply with regulations related to minimum capital requirements, governance, transparency and reporting, among others. Furthermore, all of them involve investors, which must meet certain criteria to be considered as Qualified Investors, as defined by the FRA, and who are by law required to form part of the shareholding structure of such companies.

Fund managers, who are responsible for managing the fund's assets and operations, must also obtain a licence from the FRA and comply with its rules and regulations.

2.4 Particularities

As is the case with investments in portfolio companies through offshore structures, most VC funds are established offshore in jurisdictions familiar to international investors, requiring parallel funds in Egypt for local LPs, notably state-owned banks and publicly owned insur-

ance companies. Recently, a draft law approved by the Senate aims to introduce limited partnerships similar to UK structures, pending parliamentary approval.

That said, it is important to highlight that the VC environment in Egypt is shaped by a growing number of institutional and governmental initiatives aimed at supporting early-stage and SME (small and medium-sized company) investments. Notable efforts include the following.

- Avanz Capital, a fund-of-funds model that channels capital from domestic financial institutions into VC funds. The establishment of Avanz came in response to the need to expand the financing base to SMEs. The Central Bank of Egypt (CBE) urged banks to invest in: (i) direct investment funds; and (ii) funds of funds, which in turn both invest in SMEs, and to consider their contributions/investments in the share capital of such funds as part of a requirement for banks to allocate allocate 25% of their portfolio of facilities exclusively to SMEs, whether as an *"Angel Investment"*, *"Venture Capital or as"*Growth Funding".
- Egypt Ventures, a government-backed fund investing directly in startups.
- The Micro, Small and Medium Enterprise Development Agency (MSMEDA), which collaborates with the World Bank to provide funding and capacity-building to entrepreneurs.
- The initiatives of the Technology Innovation and Entrepreneurship Center (TIEC), which stands out for its incubation programmes, broad geographic reach, and support in product development.

Additionally, as explained in more detail in **4.1 Subsidy Programmes**, the government has significantly supported private accelerators such Plug and Play and 500 Global through premises provided by the Ministry of Communications, partial funding by the Information Technology Industry Development Agency (ITIDA), and cooperation from entities such as Ahly Bank.

Furthermore, the SME Law issued in mid-2020 came with very promising provisions which, to the best of our knowledge, have not caught the VC ecosystem's attention. These provisions, if properly implemented, could have a very positive impact on the VC industry. The SME Law proposes monetary incentives to investment funds and companies established with the purpose of financing SMEs. This incentive will apply at the time of exit. The incentive programme is yet to be finalised by the Board of Directors of the SME Development Authority.

The FRA also launched its first regulatory sandbox in November 2024 to support financial innovation.

3. Investments in Venture Capital Portfolio Companies

3.1 Due Diligence

Due diligence practices in Egypt have matured significantly. In the past, investors often relied on high-level reviews. However, following several challenging investments, there is now a greater focus on detailed assessments, in particular in connection with intellectual property (IP) rights, ownership structures and regulatory licensing. This shift is contributing to more informed investment decisions and improved risk management. Consequently, due diligence over startups in Egypt currently requires meticulous planning, coordination and communication among all parties involved, alongside the engagement of

qualified and experienced advisors, such as lawyers, accountants, and technical experts.

Furthermore, due to increased regulation in sectors such as fintech, which have stringent technology-related requirements, certain sectors, including e-payments and NBFS, require prior regulatory approval (from the CBE in the event of e-payment or the FRA for NBFS) before due diligence can proceed, affecting overall timelines.

Additionally, the Egyptian Competition Authority has recently issued guidelines governing the exchange of information between competitors during the due diligence process, particularly in the context of transactions that may result in economic concentration.

3.2 Process

Engagement of Counsels

In investment rounds, it is customary for both the investor and the company to engage separate legal counsel. Where multiple investors are involved, each may also choose to retain its own advisor rather than appointing a single representative. While Egypt has a well-established community of experienced practitioners in private equity, the market for VC remains relatively nascent in terms of the number of professionals with deep, specialised VC expertise (whether legal, financial or technical). This evolving landscape may, at times, influence the pace and execution of financing rounds, particularly in the absence of dedicated, locally adapted VC templates such as those developed by the National Venture Capital Association (NVCA) and the British Venture Capital Association (BVCA).

Expected Timeline

The duration of financing rounds in Egypt can vary widely depending on the maturity of the company, deal complexity, and number of stakeholders involved. VC transactions no longer take a few months to be concluded. Currently, VC transactions – particularly those involving international investors and multiple legal layers – may extend to twelve to fifteen months. This extended timeline, driven primarily by rigorous due diligence requirements and negotiations and execution of agreements overriding any existing contractual arrangements concluded between the founders, among themselves, or with early investors, has resulted in more frequent use of tranche-based funding structures.

Facilitation of New Investor Entry

When investments are structured directly at the level of Egyptian companies, it is common for savvy founders to anticipate future funding rounds during their initial negotiations with early investors. At this stage, they often seek to include clauses in the original agreements that facilitate the entry of future investors – such as provisions requiring existing shareholders to waive their pre-emption rights in capital increases dedicated to onboarding new investors (subject to certain contractually agreed criteria). This approach ensures that future investors can acquire their desired stake in the company without being constrained by proportionate participation rights.

3.3 Investment Structure

In light of prevailing offshore acquisition trends, many investment structures tend to reflect international standards. Domestically, however, share classes and preferences are governed by the Companies Law, which provides an exhaustive list of permissible preferences – namely, voting rights, dividend entitlements and liquidation proceeds. The law further prohibits combining voting and liquidation preferences, and mandates equal treatment of shares within the same class in terms of rights, obligations, and limitations.

While the law does not impose a specific cap on the extent of preferential rights an investor may enjoy, it has been observed that requests for preferences exceeding twice the rights of ordinary shares may meet with some resistance at implementation level.

Also, Egyptian limited liability companies (LLCs) cannot issue preferential shares, which may prove impractical for portfolio companies if they are established as such.

3.4 Documentation

In offshore jurisdictions, early-stage financing rounds are frequently structured using convertible instruments such as SAFEs (Simple Agreements for Future Equity) or convertible notes – tools that offer flexibility and efficiency for both investors and founders. In contrast, Egyptian onshore transactions remain anchored in conventional legal documentation, including SHAs, SSAs, and disclosure letters. This divergence is largely due to the limited enforceability of non-traditional instruments under Egyptian law, which necessitates careful reliance on well-drafted, formal agreements.

In response to repeated calls from industry players for more flexible investment tools, a recent decree marks a promising development in Egypt's legal framework. It now permits the registration of convertible instruments with the Misr Central Clearing, Depository and Registry (MCDR) and allows for an exception to the general prohibition on executing cashless transactions at the time of debt-to-equity conversion. While this is a welcome step toward aligning local practice with international norms, the underlying legal mechanism required to operationalise such conversions is yet to be put in place, leaving some uncertainty around implementation.

At present, Egypt lacks a centralised body responsible for developing standardised VC documentation, similar to the role played by the BVCA in the UK or NVCA in the US. While there was an early attempt by Cairo Angels – an angel investment network that has since ceased operations – to lead an initiative for market-standard documents, the fruits of these efforts remain incomplete, and the initiative has yet to gain traction in the wider VC ecosystem.

Looking forward, there is cautious optimism that this gap may soon being addressed. The Memorandum of Understanding signed in 2025 between MSMEDA and the Egyptian Private Equity and Venture Capital Association (EPEVCA) could potentially serve as a vehicle to revive and support institutional efforts to establish locally adapted, standardised VC documentation – an essential step toward a more coherent and investor-friendly ecosystem. While no formal commitments have been made, it is hoped that this collaboration might help catalyse progress in this direction.

3.5 Investor Safeguards

Since many acquisitions are made offshore, they generally follow established offshore market practices and standards. VC investors commonly secure liquidation preferences, anti-dilution and pre-emptive rights. Please see **3.7 Contractual Protection** for more details.

3.6 Corporate Governance

Typically, since investments in Egyptian startups involve offshore SPVs – commonly located in jurisdictions such as the Netherlands and, more recently, Singapore – the governance standards of these jurisdictions apply, supplemented by robust oversight mechanisms directed from the offshore parent entity to the Egyptian subsidiar-

ies with clear contractual protections rights for the investors.

If the investment is directly at the level of Egyptian-incorporated entities, governance practices will depend on the company's legal form. LLCs, preferred by startups for their simplicity – so long as no sector-specific law applies requiring a vehicle other than an LLC – lack boards of directors; instead, governance is managed through a manager(s) which is/are normally from among the founders, a set of reserved matters and Key Performance Indicators (KPIs) established for the appointed managers. JSCs include formal board representation requirements along with reserved matters. Although effective structures for passive investors, CLSs remain under-utilised despite their longstanding legal availability.

3.7 Contractual Protection

If the transaction is structured through an offshore SPV, standard contractual protections rights as adopted offshore will typically be followed. If the transaction is structured directly through an Egyptian entity, a similar comprehensive set of contractual protections will usually be negotiated, although it should be noted that, under Egyptian law, the remedy for breach is generally limited to damages, and there is no specific performance remedy within the same meaning as that which exists offshore. This limitation is particularly relevant for exit-related provisions such as tag-along and drag-along rights and call/put options.

Standard documentation mainly includes the following:

- Investor's management rights, such as a list of reserved matters which require investor consent and typically cover: (i) issuance of new securities or changes in share capital (to protect against dilution); (ii) creation of encumbrances or third-party rights over company assets; (iii) approval of the annual budget and business plan; (iv) incurrence of debt over a certain threshold; (v) changes in the company's business; and (vi) amendment to management or board structure, among others.
- Exit provisions such as: (i) lock-up provisions on founders and other anchor investors; (ii) tag-along and drag-along rights; (iii) restrictions on changes of control; (iv) limitations on transfer to competitors; and (v) call or put options as deadlock resolution mechanisms or for if certain KPIs are not met by the founders.
- Non-compete provisions, which may be considered more aggressive than what is typically seen offshore, reflecting investor concerns about founder re-entry into the market.
- Standard representations and warranties, covering both core (eg, authority, ownership) and business-specific (eg, compliance, IP, financials) matters.
- Investors' information, inspection and reporting rights.
- KPIs for the company's managers, which are either included in the SHA or documented separately.

In Egypt, there is a strong preference to reflect SHA terms – particularly governance-related terms – in the company's AOA to the extent legally possible. Alternatively, parties may agree to ratify the SHA through necessary corporate procedures and treat it as a part of the AOA.

4. Government Inducements

4.1 Subsidy Programmes

Government support includes both financial and regulatory incentives. Under the SME Law, tax incentives are available to funds that invest in qualifying SMEs.

The government actively supports the VC ecosystem through a number of initiatives. These efforts, aimed at improving access to capital, streamlining regulatory approvals, and modernising the legal framework to make Egypt a more attractive destination for early-stage investment, include the following.

- ITIDA initiatives – in collaboration with global accelerators, venture capital firms and local stakeholders, ITIDA plays a pivotal role in equipping Egyptian startups with the tools, mentorship and resources necessary to thrive in competitive markets.
  (a) *Scale Up Program launched in partnership with 500 Global* now approaching its third season, this seven-week programme is scheduled from 1 May to 10 July 2025, and targets Egyptian startups at the Pre-Series A and Series A stages. Participants benefit from tailored mentorship, proven growth frameworks and access to 500 Global's extensive investor network. Additionally, they receive a year of complimentary office space at the Creativa Innovation Hub in Giza, fostering collaboration and innovation. This partnership underscores ITIDA's commitment to empowering entrepreneurs and positioning Egypt as a hub for scalable, tech-driven businesses.
  (b) *Plug and Play Cairo Program* similarly, ITIDA has joined forces with Plug and Play, one of the world's largest innovation platforms. This programme offers startups practical workshops, expert mentorship, and access to regional and international investment opportunities. Participants are also provided with office space at the Creativa Innovation Hub in Heliopolis. These efforts aim to accelerate the growth of Egyptian startups while connecting them to global markets.
- MSMEDA and EPEAVC collaboration – in addition to the above, in February 2025, MSMEDA and the Egyptian Private Equity and Venture Capital Association (EPEAVC) signed a Memorandum of Understanding to bolster Egypt's entrepreneurial ecosystem. This collaboration focuses on launching specialised support and training programmes aimed at enhancing the capabilities of investors and investment managers in direct investment and venture capital.
- MSMEDA and World Bank collaboration – partnerships with MSMEDA and the World Bank offer additional capacity-building and funding support for high-potential ventures.
- Ministerial Group for Entrepreneurship – most importantly, keen to ameliorate the VC ecosystem, the Ministerial Group for Entrepreneurship is currently working on a Startup Charter. The objective of this policy framework is to offer clarity for both founders and investors, outlining key incentives, regulatory processes and protections. It plays a vital role in lowering entry barriers and improving transparency.

4.2 Tax Treatment

As stated in **2.2 Fund Economics**, at the level of VC funds or companies, unlike private equity activities, VC structures in Egypt benefit from tax treatment that avoids double taxation, meaning that investment income is taxed only once and not at the fund level and again at the level of the

LPs. This approach is consistent with international best practices, and is considered a positive feature of the Egyptian regulatory framework.

For portfolio companies, a progressive tax rate is applicable to small projects. In accordance with Law No 6 of 2025, projects with turnover of less than EGP20 million, as detailed in the law, benefit from reduced corporate tax rates ranging from 0.4% to 1.5%, based on turnover level. For example, enterprises with annual revenues of between EGP500,000 and EGP2 million are taxed at 0.5%.

4.3 Government Endorsement

See **4.1 Subsidy Programmes**.

5. Employment Incentives

5.1 General

Incentive schemes for employees in Egyptian startups largely depend on the corporate structure of the start-up. Where employees work for an offshore holding entity that owns the Egyptian operating company, global standards on equity-based incentives – such as stock options, restricted stock units or phantom shares – can be implemented in line with the legal and tax regimes of jurisdictions such as the Netherlands or Singapore. In these cases, it is common to see structured vesting schedules (eg, four-year vesting with a one-year cliff) and employee participation in long-term incentive plans designed to align interests with the growth of the company.

However, when employees are directly employed by an Egyptian operating company, the applicable local legal framework must be considered. Under Egyptian law, only companies legally structured to issue shares are permitted to issue equity-based incentives in the form of stock options to employees. In contrast, LLCs are not legally structured to issue equity to employees, and typically rely on cash-based bonuses or profit-sharing arrangements as incentive tools.

5.2 Securities

If the incentive is to be through ESOP in an Egyptian JSC, the law provides for three systems to implement it:

- *Grant of free shares* under this system, the beneficiaries are granted free shares distributed over several years. The transfer and disposal of shares to the beneficiary are subject to a three-year lock-up period (this may be adjusted to one year, in line with the company's vision). If the beneficiary leaves, resigns, or is dismissed before the end of the grant period, their right to the granted shares is forfeited. In the event of the beneficiary's death, their heirs legally replace them.
- *Selling part of the company's shares at discounted prices or with easy payment terms* under this system, the sales contract between the company and the beneficiary governs their relationship. If the beneficiary resigns before paying the full price, they have the option to either pay the remaining amount or recover what they have paid based on the share price at the time of their resignation, within seven working days from the resignation date. The shares in this case are subject to a lock-up period during which they cannot be sold, as determined by a decision by the extraordinary general meeting.
- *Promise to sell shares* under this system, the beneficiary is granted the right to invest in certain number of the company's shares at a specific price at the end of a set period. The beneficiary has no rights to the shares subject

to the promise to sell until they meet the conditions and pay the full price. For the promise to sell to be valid, all essential elements and terms of the sale must be agreed upon, including the sales price and other conditions set by the company for the beneficiaries.

5.3 Taxation of Instruments

There is no preferential tax treatment under Egyptian law for stock-based incentives or bonuses. Any gains realised from an ESOP are subject to salary tax at the time of exercise or grant (depending on the structure), and any capital gains from a subsequent share sale are taxed according to standard capital gains tax rules. Similarly, bonuses are treated as ordinary employment income and taxed accordingly.

5.4 Implementation

With respect to the implementation of employee incentive plans by Egyptian companies – and their interaction with investment rounds – as noted in **5.1 General** – the prevailing practice is for most VC investments and corporate structures to be established offshore, with the Egyptian entity functioning primarily as the operating company. In such structures, incentive plans are typically administered at the level of the offshore parent and governed by the legal and tax frameworks of jurisdictions of incorporation such as the Netherlands or Singapore. Nevertheless, in instances where the incentive plan is to be implemented at the level of the Egyptian entity, it is our understanding that investors generally require the ESOP pool to be established prior to their entry. This approach ensures that any resulting dilution is borne by the founders and early shareholders, rather than by incoming investors.

6. Exits

6.1 Investor Exit Rights

Typical rights include lockups, call options, put options, drag-along rights, tag-along rights and rights of first refusal. Limited exit avenues have increased reliance on contractual exits and acquisitions. However, in Egypt, breaches of contractual provisions – such as call options or tag-along rights – typically lead only to claims for monetary damages. Specific enforcement mechanisms, such as share-transfer orders or injunctions, are not commonly available under local law. As a result, many investors prefer to invest via an offshore vehicle that owns the Egyptian operating entity.

6.2 IPO Exits

IPO exits remain largely theoretical in Egypt's current VC landscape. The Nilex exchange has seen limited activity, and only one SPAC transaction took place in 2024. As such, trade sales – particularly via offshore SPV structures – remain the predominant route for VC exits.

6.3 Pre-IPO Liquidity

In Egypt, the secondary market for private equity and VC investments is still in its early stages. Unlike more developed offshore markets, where secondary transactions are increasing, Egypt has seen limited activity in this area. A notable attempt was made by an Egypt-founded VC fund to establish a secondary market practice. However, the discounts offered on the secondary stakes were not attractive enough to entice investors seeking to exit their positions, leading to minimal participation. This contrasts with global trends, where the secondary market has matured significantly, providing liquidity options for investors.

7. Regulation

7.1 Securities Offerings

With respect to companies conducting VC activities, for the POF and GP/LP allowed under Decree 2018, see **2.1 Fund Structure** in relation to the information memorandum (IM). Additionally, certain criteria are required for founders of NBFS companies, such as a holding company (at least 25% of the capital must be owned by financial institutions and two-thirds by Qualified Investors), as well as criteria required from investors (see **2.3 Fund Regulation**).

If the investment is made at the level of the portfolio companies, the offering of their securities does not require an IM as they are closed entities. However, if they are structured as LLCs, the Companies Law provides that they can have no more than 50 partners.

7.2 Restrictions

Foreign investments face ongoing regulatory challenges, including currency restrictions and sector-specific acquisition requirements, despite recent improvements to the regulatory framework.

Law No 175 of 2022, amending certain provisions of Egyptian Competition Law No 3 of 2005, introduced a pre-merger control regime extending the powers of the Egyptian Competition Authority to pre-approve acquisitions that meet various criteria in terms of turnover and control. This regime was implemented as of 1 June 2024, when Prime Minister's Decree No 1120 of 2024 amending certain provisions of the Executive Regulations of Competition Law entered into force. Failure to obtain this approval may result in financial penalties.

Certain sectors also require specific regulatory approvals/notifications when acquisitions are carried out. For example, in the e-payment sector, Banking Law No 194 of 2020 imposes different obligations on both acquirers and targets in connection with transfer of ownership. If the stake to be acquired exceeds 5% of the issued share capital of an e-payment company, the acquirer is subject to a post-acquisition notification obligation from the CBE. If the stake exceeds 10% of the issued share capital, or voting rights, or any percentage that leads to control of the e-payment company, prior approval of the acquisition from the CBE will be required. Failure to observe these conditions may result in penalties, financial or other. According to FRA Decree No 178 of 2024, similar rules apply to acquisitions of NBFS companies, but under the umbrella of the FRA. Additionally, as stated in **3.1 Due Diligence**, conducting a due diligence exercise on e-payment or NBFS targets requires prior regulatory approval.

As for currency restrictions, it should be noted that there are no restrictions on the repatriation of funds. However, this is dependent on the availability of foreign currency in the investor's Egyptian bank, and is subject to the CBE's priority guidelines.

Trends and Developments

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Tahoun Law Firm is a leading corporate law firm in Cairo, recognised for its exceptional expertise in general corporate affairs, mergers and acquisitions, project finance, and oil and gas matters. It has a team of 25 highly specialised lawyers split into three divisions – Corporate, Litigation, and Procedure – ensuring tailored legal solutions for clients across multiple industries. TLF has a distinguished track record in advising high-profile clients including global corporations such as FedEx, Carrefour, Accor Hotels, Improved Petroleum Recovery (IPR), Polaris and El-Sewedy Utilities, as well as prominent institutions such as the Egyptian Ministry of Finance, the Ministry of Electricity and Renewable Energy, and the Egyptian Banks Company. With a reputation for delivering strategic and innovative legal solutions, TLF remains a trusted partner for businesses navigating complex legal and commercial challenges in Egypt and other countries in the region.

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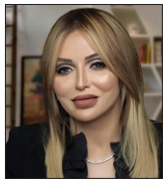

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Concession, BOT, and PPP Agreements in Egypt: An Introduction

In recent years, Egypt has been actively encouraging private sector participation in infrastructure development through Concessions, Build-Operate-Transfer (BOT), Build-Own-Operate (BOO), and Public-Private Partnership (PPP) agreements. These frameworks allow the government to leverage private sector expertise and funding while ensuring efficient service delivery and long-term sustainability. Following its agreement with the International Monetary Fund (IMF), Egypt has intensified efforts to attract private investment, particularly in sectors such as energy, transportation, healthcare, and technology. This article explores the current landscape of Concession, BOT, and PPP agreements in Egypt, highlighting key trends, legal frameworks, and challenges that stakeholders should consider.

Egypt was the first country in the region to issue a Public-Private Partnership law and to amend its procurement law to execute long-term concessions with the private sector. However, despite these legal advancements, it has not fully realised its potential in executing concessions and other PPPs over the past decade.

Legal Framework and Regulatory Environment

The PPP law

Egypt's legal framework for PPPs was significantly strengthened with the enactment of Law No 67 of 2010, commonly referred to as the PPP Law. This law provides a comprehensive regulatory framework for PPP projects, outlining the roles and responsibilities of public and private entities, as well as the procedures for project approval, tendering, and implementation. The PPP Law also established the Public-Private Partnership Central Unit (PPPCU) under the Ministry of Finance, which serves as the primary regulatory body overseeing PPP projects in Egypt.

Concession and BOT agreements

Concession, BOO, and BOT agreements are governed by Law No 182 of 2018. These laws provide the legal basis for private sector participation in public infrastructure projects, allowing private entities to design, build, finance, operate and maintain public assets for a specified period before transferring ownership back to the government. The Egyptian government has increasingly relied on these models to address infrastructure gaps, particularly in the energy and transportation sectors.

Key Trends in Concession, BOT, and PPP Agreements

Energy sector dominance

The energy sector has been the primary beneficiary of Concession, BOT, and PPP agreements in Egypt. The government has prioritised renewable energy projects, particularly solar and wind, to meet its ambitious target of generating 42% of electricity from renewable sources by 2035. Notable projects include the Benban Solar Park, one of the largest solar installations in the world, developed under a PPP model. Additionally, BOT agreements have been used to develop natural gas infrastructure, including liquefied natural gas (LNG) terminals and pipelines.

Transportation infrastructure

Egypt's transportation sector has also seen significant investment through PPP and BOT agreements. The Cairo Metro Line 3 extension and the Luxor-Aswan High-Speed Rail project are prime examples of how these models are being used to modernise the country's transportation network. These projects not only improve connectivity but also create opportunities for private

sector participation in long-term operations and maintenance.

Healthcare and education

In recent years, the Egyptian government has expanded the use of PPPs beyond traditional infrastructure sectors to include healthcare and education. The Universal Health Insurance System (UHIS), launched in 2018, relies heavily on PPPs to build and operate healthcare facilities across the country. Similarly, PPP models are being explored to develop educational infrastructure, particularly in underserved areas.

Digital transformation

Egypt's digital transformation agenda has opened new avenues for PPPs in the technology sector. The government is actively seeking private sector partners to develop smart cities, digital payment systems, and e-government services. The New Administrative Capital (NAC) project, which includes a smart city component, is a flagship initiative that highlights the potential of PPPs in driving digital innovation.

Water and sanitation

Another emerging area for PPPs in Egypt is the water and sanitation sector. With an expanding population and increasing urbanisation, the demand for clean water and efficient sanitation services has risen significantly. The government has initiated several PPP projects aimed at improving water supply and wastewater treatment facilities. These projects are critical for addressing water scarcity and ensuring public health. The private sector's involvement in this segment is expected to bring in much-needed investment and technical expertise, helping to modernise the country's water infrastructure.

Tourism and cultural heritage

Egypt's rich cultural heritage and tourism potential also present opportunities for PPPs. The government has been exploring ways to involve the private sector in the development and management of tourist sites and cultural landmarks. PPPs in this sector can help preserve Egypt's historical sites while enhancing the tourism experience. Projects such as the restoration of ancient monuments and the development of tourist facilities are being considered under PPP models. These initiatives not only contribute to economic growth but also promote cultural preservation and heritage tourism.

Innovation in financing models

One of the most exciting developments in Egypt's PPP landscape is the emergence of innovative financing models. Traditional funding mechanisms, such as bank loans and international development funds, are being complemented by newer approaches such as green bonds, blended finance, and crowdfunding. For instance, green bonds are being used to fund renewable energy projects, aligning with Egypt's sustainability goals. Blended finance, which combines public and private funds with concessional financing from international organisations, is also gaining traction. This approach reduces risk for private investors while ensuring that critical projects receive the necessary funding.

The government is also exploring Islamic finance instruments, such as sukuk (Islamic bonds), to attract investment from Gulf countries and other Islamic markets. These instruments comply with Sharia law, making them appealing to a broader range of investors. By diversifying financing options, Egypt is not only addressing funding gaps but also creating a more resilient and inclusive investment ecosystem.

The role of technology in PPPs

Technology is playing an increasingly important role in the success of PPP projects in Egypt. Building Information Modeling (BIM), for example, is being used to streamline the design and construction phases of infrastructure projects. BIM allows for better collaboration between public and private stakeholders, reducing delays and cost overruns. Additionally, blockchain technology is being explored to enhance transparency in contract management and payment processes, which can help build trust between the government and private investors.

In the energy sector, smart grids and energy storage solutions are being integrated into PPP projects to improve efficiency and reliability. These technologies not only support Egypt's renewable energy goals but also create opportunities for private companies to innovate and differentiate themselves in a competitive market.

Regional and international collaboration

Egypt's strategic location as a gateway between Africa, the Middle East, and Europe makes it an attractive hub for regional and international collaboration. The government is actively seeking partnerships with neighbouring countries and international organisations to develop cross-border infrastructure projects. For example, the Egypt-Sudan Interconnection Project, which aims to link the two countries' electricity grids, is being developed under a PPP model. This project not only enhances energy security but also fosters regional economic integration.

Similarly, Egypt is collaborating with the European Union and the African Development Bank to fund large-scale infrastructure projects, such as the Cairo-Cape Town Highway. These partnerships not only bring in additional funding but also facilitate knowledge transfer and capacity building, which are critical for the long-term success of PPPs.

The rise of social infrastructure PPPs

While traditional PPPs have focused on physical infrastructure, there is a growing trend toward social infrastructure PPPs in Egypt. These projects aim to address social challenges, such as affordable housing, public safety, and community development. For instance, the government is partnering with private developers to build low-income housing projects under PPP agreements. These projects not only provide much-needed housing but also create jobs and stimulate economic activity in underserved areas.

In the healthcare sector, PPPs are being used to develop telemedicine platforms and mobile health clinics, which improve access to healthcare services in rural and remote areas. These initiatives demonstrate how PPPs can be leveraged to achieve social objectives while still delivering value for private investors.

The impact of COVID-19 on PPPs

The COVID-19 pandemic has had a profound impact on PPPs in Egypt, both in terms of challenges and opportunities. On the one hand, the pandemic disrupted supply chains, delayed project timelines, and increased financing costs. On the other, it highlighted the importance of resilient infrastructure and accelerated the adoption of digital technologies. For example, the pandemic spurred the development of e-learning platforms and digital healthcare solutions, many of which were implemented through PPPs.

Moving forward, the government is incorporating pandemic resilience into the design of new PPP projects. This includes building flexibility into contracts to account for future disruptions and prioritising projects that enhance public health

and safety, such as wastewater treatment plants and emergency response systems.

The role of local SMEs in PPPs

Small and medium-sized enterprises (SMEs) are playing an increasingly important role in Egypt's PPP ecosystem. The government is actively encouraging the participation of local SMEs in PPP projects through subcontracting opportunities and capacity-building programs. For example, in the construction of the New Administrative Capital, local SMEs were involved in various aspects of the project, from supplying materials to providing specialised services.

By involving SMEs, the government is not only promoting economic inclusivity but also fostering innovation and competition. However, challenges endure, such as limited access to financing and technical expertise. To address these issues, the government is working with international organisations to provide training and financial support to local SMEs, enabling them to compete more effectively in the PPP market.

The future of PPPs in Egypt: a vision for 2030

Looking ahead, Egypt's PPP landscape is poised for significant growth and transformation. The government's Vision 2030 strategy outlines ambitious goals for infrastructure development, economic diversification, and sustainable growth. PPPs are expected to play a central role in achieving these objectives, particularly in sectors such as renewable energy, transportation, and digital infrastructure.

One of the key priorities is to create a more investor-friendly environment by simplifying regulations, improving transparency, and reducing bureaucratic hurdles. The government is also exploring the use of performance-based contracts, which tie payments to the achievement of specific outcomes, such as improved service delivery or reduced environmental impact.

In addition, Egypt is looking to position itself as a regional leader in PPPs by sharing its experiences and best practices with other African and Middle Eastern countries. This includes hosting international conferences and workshops on PPPs, as well as participating in cross-border initiatives that promote regional integration and cooperation.

Lessons learned from global PPP models

Egypt can draw valuable lessons from successful PPP models in other countries. For example, India's PPP framework has been widely praised for its emphasis on transparency and stakeholder engagement. The country's use of Viability Gap Funding (VGF), where the government provides financial support to make projects commercially viable, could be adapted to the Egyptian context.

Similarly, South Africa's Renewable Energy Independent Power Producer Procurement (REIPPP) programme offers insights into how competitive bidding processes can drive down costs and attract private investment. By studying these global models, Egypt can refine its own PPP framework and address some of the challenges it currently faces.

The role of civil society in PPPs

Civil society organisations (CSOs) are increasingly playing a role in shaping Egypt's PPP landscape. These organisations act as watchdogs, ensuring that PPP projects are implemented in a transparent and socially responsible manner. For example, CSOs have been instrumental in advocating for the inclusion of environmental and social safeguards in PPP contracts, particularly in sectors such as energy and transportation.

In some cases, CSOs have also facilitated community engagement by organising public consultations and raising awareness about the potential effects of PPP projects. This has helped build trust between the government, private investors and local communities, which is critical for the long-term success of PPPs.

The importance of data and analytics

Data and analytics are becoming increasingly important in the planning and implementation of PPP projects. The government is leveraging big data and artificial intelligence (AI) to identify infrastructure gaps, optimise project designs and monitor performance. For example, data from satellite imagery and IoT sensors is being used to assess the condition of roads and bridges, enabling more targeted investments in transportation infrastructure.

In addition, predictive analytics is being used to forecast demand for public services, such as healthcare and education, ensuring that PPP projects are aligned with future needs. By harnessing the power of data, Egypt can make more informed decisions and maximise the impact of its PPP investments.

Challenges and Considerations

Regulatory complexity

While Egypt's legal framework for PPPs is robust, regulatory complexity remains a significant challenge. The approval process for PPP projects can be lengthy and cumbersome, often requiring multiple layers of government approval. Additionally, inconsistencies in the interpretation and application of PPP laws can create uncertainty for investors.

Financing constraints

Access to financing is another critical hurdle, particularly for large-scale infrastructure projects. While international financial institutions and development banks have played a crucial role in funding PPP projects in Egypt, local banks often lack the capacity to provide long-term financing. This has led to a reliance on foreign investment, which can be sensitive to global economic conditions.

Political and Economic Stability

Political and economic stability are key considerations for private sector investors. While Egypt has made significant progress in stabilising its economy following the 2011 revolution, concerns about political risk and currency volatility remain. While the government has taken steps to address such concerns, implementing economic reforms and establishing investment guarantees, these risks remain a factor in investment decisions.

Environmental and Social Impact

Environmental and social impact assessments are increasingly important within the context of PPP projects, particularly in sectors such as energy and transportation. The Egyptian government has introduced regulations to ensure that PPP projects comply with environmental standards, but enforcement remains inconsistent. Additionally, social considerations, such as land acquisition and community displacement, can pose challenges for project implementation.

Conclusion

Concession, BOO, BOT, and PPP agreements have become indispensable tools for Egypt's infrastructure development strategy. These models have enabled the government to leverage private sector expertise and financing to address critical infrastructure gaps, particularly in the energy, transportation, healthcare, and technology sectors. However, challenges such as regulatory complexity, financing constraints

and political risk must be carefully managed to ensure the successful implementation of PPP projects.

As Egypt continues to pursue its ambitious development agenda, the role of Concession, BOT, BOO and PPP agreements is likely to expand further. The Egyptian government should amend further existing laws and its sector laws to avoid legal obstacles and regulate the role of governmental entities, eliminating any monopoly to certain sectors by the government or unfair competition by the governmental entities to private sector by acting as regulator and competitor in the same business sector. Stakeholders should remain vigilant in navigating the legal and regulatory landscape, while also considering the broader economic and social implications of these projects. By addressing these challenges, Egypt can unlock the full potential of PPPs to drive sustainable economic growth and improve public services.

FRANCE

Law and Practice

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Gide Loyrette Nouel was founded in 1920 and is one of the largest law firms in France, and the first to have developed a significant international presence, with 11 active offices over four continents. With more than 350 lawyers, the Paris office proposes one-stop-shop assistance and covers transactional and litigation legal work on complex and cross-border investment projects. With EUR6.2 billion raised over the last 17 years and, on average, 70 deals a year, Gide has a leading venture capital team advising both investors and start-ups, while offering clients a comprehensive range of business-focused services. Gide's team combines first-rate legal expertise with in-depth knowledge of the mechanisms of equity financing. The firm assists its clients on every aspect of their transactions, including the drafting and negotiation of investment protocols and shareholders' agreements, the issue of composite securities, and management and employee incentive plans. It has long-standing experience across a wide variety of sectors.

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1. Trends

1.1 VC Market

Mirroring 2023, fundraisings on the French market in 2024 were stable (723 versus 715) representing a total of EUR7.77 billion (compared with EUR8.3 billion the year before). Landmark 2024 venture capital (VC) transactions included:

- Mistral AI (EUR600 million in Series B, EUR385 million in Series A);
- Poolside (USD500 million);
- Electra (EUR304 million);
- HR Path (EUR250 million); and
- HysetCo (EUR200 million).

Some new unicorns emerged on the French tech market, notably Pennylane (with a EUR150 million Series B fundraising) and Pigment (with a USD145 million Series D fundraising).

2024 was a slower year in terms of exits (353 vs 405 in 2023), but also saw some significant deals such as the purchase of Neoen by Brookfield (LBO).

Finally, 2024 was a good year in terms of value for IPOs (EUR754 billion vs EUR291.3 billion the previous year), with five listings.

1.2 Key Trends

The following key trends were observed in 2024:

- an increase in distressed fundraising, with historical investors requesting either a multiple on their liquidation preference (2x or even 3x) or an upgrade of their historical shares into the newest class of shares;
- a concentration of the number of large rounds (over EUR50 million) and late-stage financings, reflecting VC's focus on profitability;
- stability in the number of early-stage financings (pre-seed and seed), which remain dynamic; and
- confirmation of the shift in key industries: AI, data and greentech, with a continuing decline in life science and internet services.

France remains the main VC market in Europe, ranking ahead of the UK and Germany. US investors continue to lead foreign VC investments in French tech.

In light of a globally subdued market for VC investments, valuation has declined, raising interest among VC investors in start-ups showing EBITDA and aggressive liquidation preferences.

1.3 Key Industries

2024 confirmed the trends observed the year before: (i) Artificial Intelligence remains a major market, and accounted for about 20% of VC investments (including, in particular, Mistral AI and Poolside AI), and (ii) greentech remained attractive, with a significant increase in fundraisings (notably Electra and Hysetco).

2. Venture Capital Funds

2.1 Fund Structure

Venture capital fund (VC Fund) structures differ according to the type of investor involved. For retail investors, the most common structures are:

- Venture capital funds (*Fonds Commun de Placement à Risque* – FCPR);
- Innovation common investment funds (*Fonds Commun de Placement dans l'Innovation* – FCPI); and
- Regional investment funds (*Fonds d'Investissement de Proximité* – FIP).

For institutional investors, the most common structures are:

- Professional private equity funds (*Fonds Professionel de Capital Investissement* – FPCI); and
- French limited partnership (*Société de Libre Partenariat* – SLP). It should be noted that funds structured in the form of SLPs are the most commonly used to date.

These funds must be managed either by:

- a French management company approved by the French Autorité des Marchés Financiers (AMF) and authorised to act as such under Directive 2011/61/EU (AIFM Directive); or
- a management company authorised in the EU that also complies with the requirements of the AIFM Directive. These management companies can be full-scope alternative investment fund managers (AIFM) (as defined by the AIFM Directive) or sub-threshold AIFMs. (In the latter case, most of the regulatory requirements of the AIFM Directive still apply by virtue of French local regulatory rules.)

Other types of investment vehicles include limited-liability companies used by professional investors and club deals formed by business angels.

The corporate documentation generally established to govern the affairs of the VC Fund comprises by-laws, prospectuses and subscription agreements and ancillary documents (SFDR appendix and KID PRIIPS, when applicable).

As per the contractual documentation, there can also be a shareholders' agreement and side letters. The governing documents of a retail fund (FCPR, FCPI or FIP) must comply with detailed French law requirements for the fund to be approved by the AMF. Therefore, investors in a retail fund generally do not have the flexibility to negotiate the terms or to request protection in addition to that already provided by the by-laws.

2.2 Fund Economics

The *"Funds Principals"* of VC funds mainly participate in the economics of these funds through carried interest mechanisms. Carried interest remunerates the performance of the management team in selecting potentially attractive investment opportunities and aligns the interests of investors when it comes to realising the expected capital gains on the sale of these investments.

In France, carried interest is structured through the subscription of specific fund units or shares, which generally represent one (1)% of the size of the fund. Carried interest units or shares are subscribed by the management company, its employees or its directors, in return for a capital investment. This capital investment is released pari passu with the fund's other investors.

According to the established practice, the share of the capital gain attached to carried interest units or shares is generally twenty (20)% of the total capital gain for a direct fund, after payment of a priority return to the investors.

The carried interest mechanism in France is subject to special tax treatment. Under this special tax treatment, distributions and gains made by the directors and employees of a management company from holding carried interest units or shares in a fund are subject to a taxation as capital gains (*plus-values*) rather than as wages and salaries (*traitements et salaires*), provided that certain conditions are met.

The relationship between the holders of carried interest units or shares and the management company is the subject of *"vesting agreement"*. The purpose of this agreement is to define the terms and conditions under which holders of carried interest units or shares will be required to sell such units or shares in the event of voluntary or involuntary termination of their employment contract. The vesting agreement includes a schedule for determining the portion of carried interest that the holder may retain in the event of voluntary or involuntary termination. The vesting agreement also covers cases of good leaver and bad leaver.

In addition, the governing documents of VC funds that are dedicated to professional/non-retail investors are more frequently negotiated by investors because French laws and regulations allow the flexibility for a wide variety of terms. Investors negotiate provisions that are commonly sought by investors in global PE funds, for example:

- key persons and change-of-control provisions;
- fault and no-fault removal of the management company;
- limitations relating to raising a successor fund;
- management and other fees;
- reporting and environmental, social and governance (ESG) obligations; and
- advisory committee membership.

2.3 Fund Regulation

VC Funds open to retail investors (FCPRs, FCPIs and FIPs) must be authorised by the AMF before both:

- formal establishment of the entity; and
- marketing its interests to prospective investors.

VC Funds limited to non-retail/professional investors (FPCIs and SLPs) must be notified to the AMF within one month after their formation. Since the implementation of the AIFM Directive, the marketing of interests in a VC fund must comply with French regulations relating to:

- public offerings (VC funds that are offered to the public require the AMF's prior approval of the offering terms);
- solicitation (VC funds must not solicit if they are not approved for marketing either through a marketing passport or under the French local marketing regime); and

- marketing regime (the AMF's prior approval is necessary for a VC fund to benefit from the marketing passport or to be authorised to market under the French local marketing regime).

The available, limited, private placement exemptions are mostly:

- contact with an investor on a reverse solicitation basis;
- contacts with managers of funds authorised to operate in France (either by the AMF or through an EU passport) if the VC fund is marketed as an eligible investment for the funds managed by those managers; or
- contact with managers of third-party accounts authorised to operate in France (either by the AMF or through an EU passport) if the VC fund is marketed as an eligible investment for the portfolio managed by those managers. *"Corporate ventures"* are the only types of structure that are not regulated as such, and involve a single institutional investor. These funds are often set up by large groups and specialise in the group's sector of activity.

Depending on the type of investor, the regulatory requirements are more or less flexible. Retail investors are entitled to a higher level of protection than institutional investors. VC Funds must in any case comply with the rules applicable to the type of fund set up, whether these are the relative rules contained in the French Monetary and Financial Code or the rules established by the AMF for each type of VC Fund. The rules governing the AIFM and the depositary of the fund should also apply.

2.4 Particularities

Venture capital initiatives are strongly supported by the French public authorities, and this market is expanding quickly. This is the case, for example, with Bpifrance (the French public investment bank), which finances and/or structures a large number of venture capital funds to enable the growth of developing companies in the fields of innovation (Bpifrance is behind around thirty (30)% of the amounts invested in seed and venture capital in France).

The *"Tibi"* initiative should also be highlighted. The aim of the Tibi label funds is to develop the financing of tomorrow's technological leaders while promoting the decarbonisation of the economy. Institutional investors, including the *Caisse des Dépôts et Consignations* and Bpifrance, have committed to investing in these funds. To date, EUR7 billion has been committed.

Data available for the first half of 2024 suggest that fundraising for investment funds dedicated to the innovation sector was lower than for 2023. More than EUR754 million was raised during the first half for over 41 vehicles. Consolidated data for 2024 is expected to be available soon.

Continuation vehicles are expending on the French market and the French private equity association (France Invest) published guidelines at the end of December 2024 indicating how such funds could be established and managed.

3. Investments in Venture Capital Portfolio Companies

3.1 Due Diligence

For early-stage companies, VC investors conduct red-flag legal due diligence, in addition

to financial and business due diligence, plus, sometimes, a technical due diligence and background check of the founders. The legal due diligence covers the following.

- Corporate law (including status of the founders) and capitalisation table.
- Employment law.
- Intellectual property and IT law (including more recently compliance with AI Act).
- Data protection law (compliance with General Data Protection Regulation ((EU) 679/2016) (GDPR) or similar regulation).
- High level review of top 10/20 contracts.

For larger financing rounds, due diligence may also cover the following additional topics.

- Commercial/competition law.
- Financial law.
- Regulatory law.
- Tax law.

3.2 Process

New financing rounds usually take between one and two months from execution of the term sheet, depending on due diligence, structure of the investment and negotiations.

Usually, and for the sake of efficiency, counsels to the company (who also advise the founders) are in charge of leading negotiations and coordinating the various parties involved, including:

- new investors (and their counsels, generally appointed by the lead investor);
- existing investors (and their counsels, in particular in case of reinvestment); and
- business angels/employees (who generally have no counsel).

Fees of the participating investors' counsels are usually re-invoiced to the company (within a certain cap negotiated in the term sheet).

Although French corporate rules provide that a capital increase may be voted by a 50% or a two-thirds majority of the shareholders, the structuring of the deal and the rights requested by investors (notably liquidation preference and drag-along rights) generally require the prior consent of all (or virtually all) holders of securities (including ESOP – Employee Stock Ownership Plan – holders). The company's corporate and contractual structure must be organised accordingly from the early stage of financings.

3.3 Investment Structure

In most cases, investors subscribe to preferred shares with certain rights (notably liquidation preference rights, anti-dilution ratchet rights and information/audit rights). For major investors, preferred rights may also include the right to appoint board member(s) and veto rights on key decisions.

Preferred rights may be defined by either: (i) the certificate of incorporation (*"statutory preferred shares"*) or (ii) the shareholders' agreement (*"ordinary shares labelled as preferred"*).

Statutory Preferred Shares

The preferred rights are reflected in both the shareholders' agreement and the certificate of incorporation. However, the issuance of such preferred shares requires that:

- a court-appointed auditor (or an auditor appointed unanimously by the shareholders) delivers a report to the shareholders on the impact of the issuance of statutory preferred shares; and

- in most of the cases, that the holders of each type of securities giving access to the share capital give consent to such issuance of a new category of preferred shares.

This process generates delays (and costs) and is only recommended if the company already has pre-existing statutory preferred shares. In addition, statutory preferred shares are not available to individuals eligible for certain beneficiary tax regimes in France (in particular the *Plan d'Epargne en Actions* – PEA).

Ordinary Shares Labelled as Preferred

Investors' rights are solely provided in the shareholders' agreement, not in the certificate of incorporation. There's a stronger trend in the market favouring this structuring, even in the case of larger financings.

Finally, please note that certain early-stage startup can issue *"BSA AIR"* (warrant), equivalent to a SAFE (Simple Agreement for Future Equity) in the US, with a cap, floor and/or discount over the next round to be negotiated. Note that, unlike a bond or note, there can be no cash repayment of BSA AIR investment in downside events (absence of financing or liquidity).

3.4 Documentation

Key documents in VC transactions are as follows.

- Term sheet, generally non-binding, drafted by the lead new investors and executed by the company and, as the case may be, the founders and the main existing investors. One- to eight-page documents detailing the main conditions of the transaction and the provisions of the shareholders' agreement. The company usually grants a three-to-six-week exclusivity period for new investors to complete the transaction.
- Main shareholders' agreement executed by major investors and the founders detailing governance (composition and organisation rules of the board; veto rights on certain decisions; information and audit rights); share transfer rules (right of first refusal and tag-along rights); security issuance rules (priority or pre-emption right in new issue); liquidity (drag-along rights and liquidity process); liquidation preference; and specific provisions for the founders (leaver call option, non-solicit, non-compete and IP provisions).
- Short-form shareholders' agreement executed by minority investors and ESOP holders with limited rights (full tag-along rights) and key undertakings (right of first refusal to the benefit of main investors/active founders, drag-along rights and acknowledgement of liquidity process) and liquidation preference, consistent with the main shareholders' agreement.
- Representations and warranties agreement providing for representations given by the founders and/or the company, and indemnification mechanism (generally through transfer or issuance of shares).
- Investment agreement detailing the structure of the transaction; generally executed for larger transactions or complex investments (with several tranches or conditions precedent); the investment agreement usually includes the above-mentioned representations and warranties.
- Shareholders' resolutions approving the transaction, the issuance of shares, the ESOP and appointing board members (generally through shareholders unanimous decisions deed).
- Updated bylaws.

- Subscription forms executed by each subscriber.

Contrary to other VC markets, France does not have standardised investments documents even if there is a strong market practice on the main terms of the investments. Some projects have been developed to provide guidelines to founders and investors by certain think tanks and law firms without being prevalent on the market.

3.5 Investor Safeguards

"Downside scenario" protections include the following.

- A ratchet right entitling the investors, in the event of a down-round within a two- to five-year period from financing closing date, to benefit from additional shares reducing, therefore, price per share of their investment. This ratchet is usually structured through warrants attached to the shares (but can also be structured as an adjustment to the conversion ratio of preferred shares). Ratchet rights generally use a weighted average formula and can include *"pay to play"* condition.
- Liquidation preference, entitling the investors to be repaid for their investment before the other shareholders if a liquidation, sale or merger of the company takes place:
  (a) non-participating liquidation preference – investors receive the maximum between their pro rata of the total proceeds and their investment amount (1x non-participating, which is the most common protection); or
  (b) participating liquidation preference – investors receive their investment amount plus their pro rata of the remaining total proceed (if any).

Please note that ordinary shareholders cannot be completely stripped of all their financial rights. French market practice has imposed that all shareholders receive a minimal amount (even when proceeds are lower than the investment amount). This amount is generally equal to the nominal value of the shares or to a percentage of the proceeds (between 1% and 10%) and is to be allocated prior to the liquidation preference.

Recent market conditions have led to a greater focus on liquidation preference rights, with a preference of two or three times to reward risks in downside scenarios (see **1.2 Key Trends**).

- Anti-dilution rights in the event of a new share capital increase. Investors will benefit from an anti-dilution protection entitling them to maintain their percentage of shareholders and may also negotiate a priority right over future financings.

3.6 Corporate Governance

Founders remain in charge of the management of the company, but investors usually negotiate the following rights:

- the right to appoint one or more board members or observers;
- the right to convey board meetings and shareholders meetings;
- veto rights through a board-qualified majority of the board (ie, the majority including the investor board member) on certain operational decisions including approval of annual budget, capex over a threshold, compensation of the founders, related-party transactions, appointment/removal of key employees, sale of assets, ESOP, etc;
- veto rights through the investors' majority (ie, approval of a percentage of the preferred shares) on certain protective decisions

(number of board members, distribution of dividends etc);
- the right to dismiss, with or without cause, the officers of the company (above a certain shareholder threshold); and
- audit and information rights.

3.7 Contractual Protection

Within the context of a financing, representations and warranties on the company and its subsidiaries covering a large scope (corporate, capitalisation table, IP, employment, tax, insurance, accounts, financing, contracts etc.) are granted by the founders (generally at an early stage) and/or the company.

The following limitations are usually provided:

- information fairly disclosed in the agreement (no reference to data room);
- time limitations: between 12 and 24 months, except for tax and certain fundamental representations; and
- financial limitations:
  (a) de minimis (ie, the minimum amount of damages suffered either by the investor or by the company), generally equal to 0.1% of the invested amount;
  (b) the threshold (ie, the minimum amount of cumulated damages entitling the investor to claim) is equal to 1% of the invested amount; and
  (c) the cap (ie, the maximum amount that may be claimed by the investor) is equal to the invested amount (if founders are warrantors, then the cap for them is equal to one or two times their annual salary).

Indemnification can be paid in cash or in shares of the company, usually at the sole decision of the warrantor.

4. Government Inducements

4.1 Subsidy Programmes

The French government provides a variety of programmes to encourage equity financing in growth companies. These programmes are designed to reduce risk and increase the appeal of investing in startups. They include direct financial support, tax incentives and special statuses that confer tax advantages. The landscape of incentives is subject to change, reflecting the government's ongoing commitment to fostering a dynamic and innovative business environment. The complexity of these programmes and their application to specific situations can be significant, and the details of each are subject to specific rules and conditions.

Such programmes include the following.

- Bpifrance, the French public investment bank, which is a key player in this ecosystem. It offers a range of financial instruments and support services for start-ups and SMEs (small and medium-sized enterprises), including direct equity investments, co-investments, investment as LP in VC funds and various loans and guarantee schemes.
- The Young Innovative Company Status (JEI – *Jeune Entreprise Innovante*). Companies that qualify for JEI status can benefit from tax incentives (notably exemptions from corporate income tax and local taxes for a certain period) and social charge exemptions (partial or total exemptions from employer social security contributions on salaries paid to researchers and developers).
- Investment Tax Credits – France offers various tax credits to incentivise investment in growth companies. One example is the *"réduction d'impôt pour investissement dans les PME"* (Tax Reduction for Investment in

SMEs), which provides personal income tax reductions for individuals investing in small and medium-sized businesses. The French Parliament very recently introduced (Finance Act for 2024 voted in December 2023) additional tax credits to incentivise individuals to invest in Young Innovative Companies (JEI) or Particularly Innovative Young Companies (*Junes Entreprises Particulièrement Innovantes* – see above). There are annual investment caps and overall limits on the tax reduction amount.

- The Research Tax Credit (CIR – Crédit d'Impôt Recherche) tax incentive designed to encourage companies to invest in research and development activities within France. It allows eligible businesses to claim a tax credit on their R&D expenditures, which can be used to offset corporate tax liabilities or, in some cases, be reimbursed if the credit exceeds the tax due. The credit is calculated as a percentage of qualifying R&D costs, with different rates applicable depending on the size of the company and the amount spent. The CIR is a key component of France's policy to foster innovation and support the competitiveness of its industries on a global scale, and has been fairly stable over the past few years.
- The Innovation Tax Credit (CII – Crédit d'Impôt Innovation), which is a tax credit aimed at supporting SMEs that engage in innovative projects. It is similar to the above-mentioned Research Tax Credit (CIR – Crédit d'Impôt Recherche), but specifically targets innovation expenses.
- The French IP box regime allows French companies developing eligible IP assets (eg, patents, patentable inventions, software protected by copyrights, etc.) to benefit, under certain conditions, from a reduced corporate income tax rate of 10% applying to the net income deriving from the licensing or transfer of said assets.

4.2 Tax Treatment

Investment in growth/start-up/VC fund portfolio companies may entail certain tax advantages for both French individuals and entities subject to corporate income tax (CIT).

French individuals may in that respect benefit from certain tax incentives, under certain conditions, upon investment or exit of growth/start-up/VC fund portfolio companies, as follows.

- Upon entry – specific personal income tax reductions for eligible subscriptions in the share capital of SME (*"réduction d'impôt pour investissement dans les PME"*). This tax reduction generally amounts to 18% of the amount invested in the relevant SME (but may potentially be increased to 30% (or even 50%) for subscriptions in the share capital of companies qualifying as young or particularly young innovative companies (see **4.1 Subsidy Programmes**).
- Upon exit – potential application to the favourable *Plan d'Epargne en Actions* regime (PEA) – French individuals may, under this specific tax regime, be exempt from personal income tax on the capital gain realised on their investment, provided that: (i) shares were subscribed to through this specific savings plan; and (ii) the shares or proceeds from the sale of the shares are not withdrawn from the PEA before the fifth anniversary of the PEA; however, social security contributions remain applicable at a rate of 17.2%.
- The standard capital gains tax regime provides for a flat tax of 30% assessed on any capital gains, potentially increased by a surtax on high income (referred to as the *"contribution exceptionnelle sur les hauts*

revenus" or CEHR). There is no tax specificity for capital gains realised on shares of growth/start-up/VC fund portfolio companies.

4.3 Government Endorsement

The French government has implemented several initiatives to bolster equity financing activity in France. These measures are designed to support startups, small and medium-sized enterprises (SMEs) and innovation, as well as to stimulate investment in the French economy.

One of the key strategies has been the introduction of tax incentives to encourage investment in SMEs. For instance, the Madelin tax credit allows individuals investing in SMEs to benefit from income-tax reductions.

In addition, the French government has reformed savings plans to direct more savings into equity financing. The *Plan d'Epargne en Actions* (PEA) and the *Plan d'Epargne Retraite* (PER) are examples of savings plans that offer tax advantages to individuals investing in stocks or equity funds, with the aim of channelling more personal savings into the equity market.

To foster innovation, the government has set up the French Tech Initiative, which aims to promote the growth of French startups and to attract foreign talent and investors. This initiative includes the French Tech Visa, a simplified, fast-track scheme for non-European start-up founders, employees and investors to obtain a residence permit in France.

Additionally, as a member of the European Union, France benefits from EU-wide initiatives such as the Capital Markets Union (CMU), which aims to deepen the single market for capital across the EU.

5. Employment Incentives

5.1 General

In France, as in many other jurisdictions, the long-term commitment of founders and key employees is often sought through a combination of contractual agreements, equity incentives, and corporate-governance mechanisms. These tools are designed to align the interests of the founders and key employees with the success and longevity of the company, as follows.

Founders

- The shares of the founders are generally subject to transfer restrictions – a four-year lock-up (with a 10% carve-out); a proportional tag-along of the main investors; and/or a full tag-along right in case of transfer of a significant part of their shares.
- Leavers provisions – repurchase by the investors (and other active founders) in case of departure; claw-back on 100% of the shares (in the event of *"bad leaver"*) or only on unvested shares with a reverse vesting (in the event of *"good leaver"*). The acquisition price can be equal to nominal value (bad leaver); fair market value (good leaver); or discounted price (for termination for cause but without gross or wilful misconduct). The terms and conditions of the claw-back are subject to tough negotiation, and can differ from one matter to another.
- Finally, certain rights of the founders provided in the shareholders' agreement (primarily the right to appoint board members, and anti-dilution rights) are conditional on the founders being active in the company.

Key Employees

- Long-term commitment of key employees is generally secured through the allocation of founders' warrants (BSPCE – *bons de sou-*

scription de parts de créateurs d'entreprise) which allow them to subscribe, subject to vesting, to shares of the company at a given exercise price (similar to a stock option plan but with a favourable tax regime). The shares then subscribed are often subject to a call option in case of exit of the company. Alternative ESOP structures such as warrants (BSA – *bons de souscription d'actions*), stock options or free shares are also available but less frequently used given the applicable tax regime to the company and the beneficiaries.

5.2 Securities

In France, as in many other countries, there are several instruments and securities generally used to incentivise founders and employees. These are designed to align the interests of the employees with those of the company and its shareholders, and to retain key talent within the company.

Type of Instruments

- Founders' warrants (BSPCE – *bons de souscription de parts de créateur d'entreprise*) are warrants, granted for free, which allow employees to subscribe to ordinary shares at a strike price determined at the allocation date. This is the most commonly used instrument in France as it benefits from an attractive tax regime described below. The allocation is subject to several conditions, as follows:
  (a) the issuing company is less than 15 years' old and is subject to corporate income tax;
  (b) the company is at least 25% held by individuals or companies or at least 75% directly held by individuals (specific rules exist to disregard the stake of certain investment funds);
  (c) the beneficiaries must be employees of the issuing company (or of a subsidiary 75% directly held by the issuing company) or board member (if the board can be assimilated with the *conseil d'administration* of a *Société Anonyme*). Consultant, freelancer and, generally, board members of a *Société par Actions Simplifiée* cannot be allocated founders' warrants;
  (d) the exercise price of the founders' warrants must correspond to the fair market value of the underlying shares of the company at the time of allocation.
- Stock options are generally granted to employees who are not French tax residents (notably when the country of tax residency does not recognise founders' warrants locally), as the tax regime for French employees is less favourable.
- Warrants or BSA are generally subscribed to by consultant, freelance or independent board members who cannot receive founders' warrants. Unlike the latter, the fair market value of the warrants must be paid at the time of subscription, and the tax regime is less favourable (see **5.3 Taxation of Instruments**).
- Free shares: if the issuing company can no longer grant founders' warrants (eg, because it is over 15 years' old or because of its capital structure), free shares can be granted to employees and corporate officers. The number of free shares cannot represent more than 15% of the share capital (or 30% or 40% in certain circumstances) and a beneficiary cannot hold more than 10% of the share capital, provided that this threshold is determined based on the shares held by a beneficiary for less than seven years). The shares are effectively issued after an acquisition period of at least one year from granting, and the shares are then subject to a lock-up period (so the aggregate of the vesting and lock-up periods

would be at least two years). The tax regime is less favourable to that applicable to that for BSPCE (see **5.3 Taxation of Instruments**).

Main Terms and Conditions (Founders' Warrants, Stock Options and Warrants)

- Such instruments generally give right to ordinary shares (in particular without liquidation preference rights or ratchet), and are subject to a four-year vesting period with a cliff of one year – performance conditions can also be provided.
- In case of change of control, vesting is usually accelerated (and can be negotiated, in particular to provide for a US standard double trigger) and is exercised at the time, failing which it lapses.
- In case of departure, the key employees must exercise the instrument within a limited period of time (between one to three months, or six months in the specific event of a death).

5.3 Taxation of Instruments

Founders' Warrants (BSPCE – bons de souscription de parts de créateur d'entreprise)

No tax or social security contributions are incurred by the issuer/employer upon the granting/exercise of BSPCEs.

For beneficiaries, the French Finance Act for 2025 (adopted in February 2025) introduced a distinction between an *"exercise gain"* (corresponding to the difference between the fair market value (FMV) of the shares on the exercise date and the exercise price) and *"disposal gain"* (corresponding to the difference between the sale price of the shares and the FMV of the shares on the exercise date). Both gains are subject to an effective tax rate (including personal income tax and social security contributions, and unless a specific option is made) of 30% (or 47.2% if the beneficiary is employed in the group for less than three years). This technical distinction was enacted to avoid the application of a tax deferral regime on the *"exercise gain"* in case the underlying shares (received upon exercise of the BSPCE) are contributed in a tax-free rollover to a new company (therefore leading to *"dry"* taxation on the exercise gain for the beneficiaries).

The French Finance Act for 2025 also expressly prohibited subscription to the underlying shares (received upon exercise of the BSPCE) through a *Plan d'Epargne en Actions* regime (PEA); this modification applied following a favourable decision by the French Administrative Supreme Court of 8 December 2023 that overruled the administrative guidelines.

Stock Options

For the issuer – a specific employer's social contribution is due upon the granting of stock options, amounting to 30% of either:

- 100% of the estimated fair market value of the options as determined for consolidated accounting purposes (assuming the company applies international financial reporting standards (IFRS) regulations); or
- 25% of the fair market value of the shares at the granting date.

For the beneficiaries: taxation upon disposal of the underlying shares of:

- the *"exercise gain"* (corresponding to the difference between the FMV of the shares on the exercise date and the exercise price) at an effective tax rate (including personal income tax and social security contributions) of a maximum of approximately 61.6% (including deductible CSG); and

- the *"disposal gain"* (corresponding to the difference between the sale price of the shares and the FMV of the shares on the exercise date) at the effective tax rate (including personal income tax and social security contributions, and unless a specific option is selected) of 30%.

Warrants (BSA)

For the issuer – no tax or social security contributions incurred by the issuer/employer per se upon allocation/exercise of the warrants (to the extent that the warrants have been issued/subscribed to at a price reflecting their FMV).

For the beneficiaries – gains realised on these warrants are, in principle, subject to the capital gains tax regime (ie, a flat tax rate).

Despite the new rules introduced by the French Finance Act for 2025, these instruments may still be negatively viewed by the French tax authorities and particularly by the French social security authorities (URSSAF).

Free Shares

For the issuer: a specific employer social security contribution amounting to 30% of the FMV of the free shares at the end of the vesting period (ie, upon issuance of the shares, with the issuance date being at least one year after share allocation).

For the beneficiaries: taxation upon disposal of the shares (no taxation before) of:

- the *"acquisition gain"* (corresponding to the FMV of the shares at the issuance date) at an effective tax rate (including personal income tax and social security contributions) of a maximum of 38% (including deductible CSG) for the portion below EUR300,000 and 61.6% (including deductible CSG) for the portion above EUR300,000; and
- the *"disposal gain"* (corresponding to the difference between the sale price of the shares and the FMV of the shares on the issuance date) at an effective tax rate (including tax and social security contributions, and unless a specific option is selected) of 30%.

General Comments

The French Finance Act for 2025 introduced a new mechanism which may limit the application of the capital gains tax regime applicable to securities held by managers (when such securities have been granted/subscribed to or acquired in consideration for the duties performed by such managers). The capital gains tax regime may not be available for shares subscribed to/granted for free if the net gain realised by the beneficiary (calculated excluding the exercise/acquisition gains on BSPCE/stock options/free shares) exceeds a multiple of three (3) times the company's financial performance over the period between the entry and exit dates of such *"instruments"*. The portion of the net gain realised by the beneficiaries exceeding this multiple should be treated as *"employment income"* and be subject to an effective tax/social security rate of a maximum of 59%. In practice, this new mechanism is for use in situations involving *"leverage effect"* or *"ratchet"* attached to the shares held by the managers (and, therefore, primarily in LBO-type structures). The recently introduced provision is being significantly debated at present by the government and private equity professionals. Potential amendments may be voted by Parliament in the coming months and will be subject to comment by the French tax authorities in their guidelines (to be published soon).

Note, also, that the French Finance Act for 2025 introduced *"top-up"* tax (referred to as *"con-*

tribution différentielle sur les hauts revenus" or CDHR) which should only apply to income received/gains realised in 2025, and aims to provide a minimum level of taxation of 20% on high income.

In all cases:

- a surtax on high income (3% to 4%) may apply to beneficiaries; and
- the different regimes described herein are based on the French rules currently in force (it is important to be aware that tax laws change frequently, and occasionally on a retroactive basis) and offer certain options which may be applicable for beneficiaries depending on their specific situation, on a case-by-case assessment.

5.4 Implementation

The percentage of pre- or post-closing ESOP is negotiated as part of the discussion on the valuation of the company.

On the closing date of the financing round, the shareholders grant the management of the company the power to issue and grant the securities. The allocation is very often subject to the prior approval of the board at the qualified majority (ie, including the prior approval of one or two of the members appointed by the investors). This delegation of power is limited to 18 months.

The allocations are made after closing on one or several occasions.

6. Exits

6.1 Investor Exit Rights

In France, shareholder exit rights in the context of a sale, IPO, or other liquidity event are typically governed by provisions in the shareholders' agreement.

- Transfer restriction before liquidity: the transfer of shares is subject to lockup (for the founders exclusively), full tag-along rights (in case of change of control, disinvestment by the founders and sale to a non-financial investor) and, in certain matters, proportional tag along rights (on transfer by the founders).
- Drag-along rights provide that, if a shareholder receives an offer by a third party over at least 95% of the share capital, and if the offer is accepted by a certain majority of the share capital, all the shareholders are committed to transferring their shares. In the negotiation of the majority to trigger the drag-along rights, parties usually try to avoid individual veto rights (except in case of an offer before a certain period or below a certain multiple threshold).
- Liquidity provisions generally provide that the parties aim to find a liquidity solution (in the form of a sale or IPO) within a negotiated time frame. After a four- or five-year period, investors negotiate the right to appoint investment bank(s) to identify liquidity options for the company. The drag-along majorities may be amended after the liquidity period to allow the investors to force a sale of the company. In the case of pre-IPO, the shareholders' agreement may detail registration rights, lock-up provisions and undertakings to subscribe to the IPO as cornerstone investors.

The decline in the number of exits has led to new requests from the investors in terms of liquidity provisions: (i) free transfer of their shareholding as from the end of the liquidity period; and (ii) free transfer to secondary funds (*fonds de position secondaire*), applying as from the fundraising (vs only in the event of liquidation of the fund).

6.2 IPO Exits

IPOs are not a common exit strategy for French start-ups (compared to a strategic sale or private equity buy-out). Startups considering an IPO must weigh up various factors that influence the timeline, including market conditions, the maturity of the business, regulatory compliance and the amount of capital needed.

The primary listing venue in France is the Euronext Paris. The regulated market of Euronext Paris is designed for highly structured companies that have the resources to meet the requirements of European regulations, so that they can attract international investors and a more liquid market. Euronext Growth is suited to SMEs, with simplified listing and reporting requirements.

Offering structures for growth companies often involves a combination of public offerings for retail investors and private placements for institutional investors. Generally, a pricing range is disclosed at the opening of the offering and will be set at the end of the subscription period depending on the bookbuilding outcome.

6.3 Pre-IPO Liquidity

As the employee equity incentive is subject to sale restrictions, secondary market trading is needed prior to an IPO to provide liquidity for early investors and employees. Liquidity can be provided by new investors (subject to the shareholders' provisions on transfer of shares) or existing stockholders to demonstrate the support of core shareholders before an IPO. One of the main challenges is control over non-public information communicated to employees as part of the secondary. Another challenge is the valuation of the company and the secondary price, which may impact the IPO price.

The most likely situation is for one or more existing shareholder(s) to purchase shares from other existing shareholders. An acquisition offer allows existing shareholders in a private company to sell some – or all – of their shares, enabling them to cash out without having to wait for an IPO that, in theory, might be several years away. This type of acquisition offer could also simplify the company's shareholder structure ahead of a potential IPO. Once the company is listed, a tender offer can be launched to all shareholders of the company.

7. Regulation

7.1 Securities Offerings

French legal provisions that govern the offering of a company's equity securities in a venture capital transaction are primarily found in European regulations, the AMF's regulations, the Monetary and Financial Code (*"Code Monétaire et Financier"*) and the Commercial Code (*"Code de Commerce"*). These provisions are designed to protect investors and ensure market transparency.

Regulatory Framework

- Prospectus requirement – for public offerings, a prospectus approved by the Autorité des marchés financiers (AMF) is required unless an exemption applies.
- Private Placements – private placements to a limited number of investors or qualified investors (less than 150) are common in venture capital and are exempt from the prospectus requirement.
- Employee Equity Participation – specific rules apply for employee share ownership plans, which may include preferential terms under certain conditions.

Disclosure and Reporting Obligations

Companies must comply with ongoing disclosure and reporting obligations, particularly for sizeable transactions that could affect the financial markets.

Thresholds and Limits

There are thresholds for the number of investors (150 qualified investors) and investment amounts (no prospectus under EUR8 million) that, if exceeded, may trigger additional regulatory requirements.

AMF Regulations

The AMF provides regulations and guidelines on the offering of securities, including venture capital investments, to ensure investor protection and market integrity.

In practice, the complexity of these transactions often requires careful structuring to comply with the relevant legal provisions, especially when numerous employees or entitlement holders are involved.

7.2 Restrictions

In France, the scope of the government's scrutiny over foreign investments has continuously increased over the past 12 months. Temporary protective measures adopted during the COVID-19 pandemic became permanent due to geopolitical tensions and the energy crisis, whilst the scope of sensitive activities has been widened to protect French innovation.

This has led the FDI authorities, accustomed to focusing on defence matters and strategic infrastructure, to become particularly stringent on the technology sector, with increasingly tight control over innovative segments such as AI, biotechnologies, cybersecurity, photonics, data storage or semi-conductors.

This has materially affected investments by foreign VC investors (EU or non-EU) in French companies, as a very broad range of activities are now subject to the government's investigations, regardless of the stages of development of the target entities (investments of 10% or 25% of a target's voting rights may constitute eligible investments), the maturity of a project, or the amount of the investment.

In addition, the French Government may condition its approval of such investments to certain undertakings by the investor (eg, maintaining IP, R&D or industrial capabilities in France, implementing procedures to protect French sensitive data, etc.), which could hinder the integration of the target within the investor's group or the ability of the investors to exit.

Regulated Industries

Depending on the nature and size of the investment, stake acquisitions in French companies may require regulatory reviews or approvals before they can be completed. This is especially the case for investments in certain regulated industries, such as banking or insurance companies (eg, the acquisition or extension, directly or indirectly, of *"qualifying holding"* 10% or more of 20%, 1/3, 50% of the capital or votes, in a French bank is subject to prior assessment and a non-objection decision by the European and French regulatory authorities). In practice, these regulatory approvals are considered a condition for completion of the transaction and necessarily have an impact on its timetable.

Currency exchange control is not generally an issue in France, as it is part of the Eurozone, but investors must comply with anti-money laundering regulations. Banking-related regulations require due diligence and reporting, which can affect transaction timelines and complexity.

Trends and Developments

Contributed by:
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Challenging Times for the French Venture Capital Market

The French venture capital (VC) market continues to face the same issues as those observed over the past year, including more limited access to funding, fewer exit opportunities and a higher number of distressed situations. However, despite overall negative trends, there are reasons to be cautiously optimistic that the French VC space will not be affected further by these challenges to any large degree in the coming months.

Depressed VC Fundraising Activity in France

While the European VC fundraising market proved fairly resilient in 2024, the French VC fundraising environment was very depressed. Across Europe, the number of VC funds raised in 2024 declined by about 21% against 2023, whereas, in France, the number of VC funds raised over the same period fell by about 37%. In terms of the amount of funds raised, the gap between France and Europe is even wider, with the European VC fundraising market very stable (down roughly 1% year-on-year) compared to a massive drop in France of about 57% year-on-year. This gap may be explained by various factors, including the highly unstable political environment in France since summer 2024.

Following this massive decline in VC fundraising activity, available VC dry powder stands at its lowest since 2017.

Weaker Deal Activity

VC deal value remained fairly robust in France in 2024, despite a year-on-year drop of some 13%, with a total volume ranging below 2021, 2022 and 2023 levels, but above that of 2020. Europe outperformed France, with total VC deal value down just 8% roughly year-on-year. For many market observers, the drop in VC deal value not only constitutes a sound normalisation of the VC market, where assets have been overvalued for some years, but also reflects a more selective approach among sponsors to acquisition targets, with a particular focus on profitability.

In terms of deal count, France was down about 24% year-on-year, its lowest level over the past five years at least, and compared with a decline of roughly 16% for Europe versus 2023.

As equity funding has become scarcer over the past few months and investors more selective about targets, start-ups have had to find other means to address cash-shortage issues, such as cost-cutting, follow-on rounds from existing investors, or new sources of financing (such as venture debt). The decline in the volume of standard equity fundraising transactions resulted in no small part from this diversification of funding sources.

Government Support for French VCs and Start-Ups

Compared to other European jurisdictions, the French government is very supportive of the VC community.

Government-backed bank Bpifrance has continued to play a major role in the growth and stability of the French VC market. Over the past five years, Bpifrance has become the first VC investor in France in terms of deal count and the second limited partner in VC funds in France in terms of number of commitments.

Bpifrance is heavily committed across the entire French VC segment, and also supports certain targeted initiatives to specifically promote sub-sectors or positioning within the tech environment. For instance, in February 2025, it

announced that it will invest EUR10 billion to support the AI sector.

In 2019 the French government also launched the first phase of its Tibi programme to increase institutional investments into funds dedicated to tech targets. According to the government, during the first phase, close to EUR30 billion was injected into the VC ecosystem following on from EUR6 billion of initial Tibi investments.

After the success of the first phase, the second phase (Tibi 2) was launched in June 2023, under which more than 30 French institutional investors, corporates and family offices have pledged to collectively invest around EUR7 billion in eligible funds through to the end of 2026.

Subdued Exits, Few IPOs

In 2024, VC-backed exit activity fell significantly in terms of deal count, with about 138 exits compared to roughly 181 in 2023 and 187 in 2022, but progressed in terms of exit value (about EUR2.7 billion compared to about EUR1.3 billion in 2023 and about EUR1.9 billion in 2022). However, only a very limited number of exits were completed via IPO (less than 1.5%), with M&A by far remaining the main exit route.

French start-ups and their investors face the same significant headwinds in successfully completing an IPO as any other market players at present. In particular, domestic political uncertainty and geopolitical tensions have led to market volatility, the knock-on effect being greater scrutiny of current and potential valuations. There is a backlog of IPOs that were originally expected for 2022 and 2023 but that have now been postponed until after 2024/2025.

Even for natural IPO candidates among the tech companies, there remain concerns over how successful an IPO may be in the current climate, with some doubts regarding the potential of the French financial markets to match the start-up funding needs. The tender offer on French start-up Believe just three years after its IPO, followed by a proposed public buyout offer announced in April 2025, is an example that only serves to reinforce these concerns around company flotations.

However, recent developments in French laws and regulations could support fresh momentum on the IPO market. Law No 2024-537 of 13 June 2024, known as the *Loi Attractivité*, was designed to make the Paris financial markets more appealing, in particular via the introduction of multiple voting rights for newly listed companies and the simplification of share capital increases without preferential subscription rights; the French market authority (*Autorité des marchés financiers*) regulation was also amended in March 2024 to cancel the requirement for a retail tranche offering as part of IPO processes.

A Shifting Fundraising Landscape for French Tech

VC investment funds are becoming increasingly conservative, particularly in the later stages of start-up development, thereby delaying and reducing fundraising opportunities for tech companies. Hesitant to make additional investments into companies that risk seeing their valuation docked, they now more often favour smaller investments, with larger investments going to industries demonstrating greater resilience.

Downrounds

Many start-ups that still have access to VC equity financing are raising funds at lower valuations than previously. This trend began in 2022, and has continued through 2023 and 2024. Fundraising transactions carried out at lower

valuations than previously create certain specific challenges and complexities. In particular, VC investors are generally granted downround protections through warrants (*"BSA ratchets"*). Therefore, existing investors can exercise their protective warrants at the time of a downround and gain from accretion, thus making the transaction more costly for founders from a dilution perspective.

Sectoral Shifts

Most VC deal activity in France has been concentrated in the software industry, with some EUR3 billion of funds raised in 2024, marking a sharp increase (about 46%) compared to 2023, despite a steady deal count. This increase was mainly driven by strong trends around AI. As reported during the AI summit of February 2025, France had approximately 1,000 AI start-ups in 2024 (compared with 502 in 2021) that raised EUR1.9 billion over the course of the year, with certain prominent deals such as Mistral AI (EUR468 million raised) or Poolside AI (EUR453 million raised). AI will most likely remain a key industry for VC deal activity in 2025. In this respect, President Macron recently announced EUR109 billion of private French and foreign investments in AI development projects for the next few years, which could boost the VC deal activity in the sector.

On the other hand, greentech, life science and internet services, which used to be among the most dynamic sub-industries in the VC market, fell in terms of amount of funds raised in 2024 by 29%, 17% and 38%, respectively, year over year.

In 2025, start-ups operating in industries with applications in the defence industry could also see a boost in deal activity, since recent initiatives announced by the French government are aimed at raising funds for this sector. For instance, in March 2025, Bpifrance announced a future fund for retail investors (*"Bpifrance Defense"*) the purpose of which is to create a link between retail investors' savings and investments in companies active in cybersecurity and defence, including start-ups.

Profitability Over Growth

Scarcity of start-up funding has led some commentators to refer to *"French tech fire sale"* as companies come to terms with unsustainable business models.

While there are examples of companies being bought out for far less than their previous valuations, French start-ups and their VC investors are mostly adopting *"wait and see"* approach.

There has been a substantial shift in focus, from *"growth"* and *"potential"* to profitability, which continued in 2024. In 2021 and 202 *"growth"* was the watchword, and significant cash burn a standard. With financing relatively easy to come by, start-ups significantly expanded their workforces, acquired impressive offices and extended their operations internationally. The conversation has shifted. VC funds and their investors, confronted with the likelihood that their investments would not reach the same valuations in today's market, are focusing on portfolio companies achieving profitability. Start-up leaders – particularly at France's unicorns – are echoing the message, emphasising financial health and close-range profitability targets.

For some start-ups, this shift has occurred too late. Insolvency proceedings targeting small and medium-sized French companies significantly increased in 2023, with the trend continuing in 2024 and so far in 2025, the new feature being that a much higher number of start-ups – such as

Luko, Hopium, Cityscoot, BioSerenity, Masteos, Ynsect or Virtuo – have undergone distressed proceedings. Tech companies facing financial difficulties are now strongly encouraged to initiate preventive procedures, such as a mandat ad hoc or a conciliation to confidentially handle negotiations with creditors and implement restructuring steps as early as possible. As the development of the start-up environment led to an increase in the size and workforce of the companies within the segment, the insolvency approach has increasingly resembled that adopted in more traditional industries.

It should be noted, however, that distressed situations may also create acquisition opportunities for competitors or traditional corporates willing to purchase disruptive technologies at a discount.

Development of Alternative Funding Options

As traditional VC equity funding has become more difficult to access, start-ups are increasingly turning to alternative financing options to raise capital.

In line with European trends, venture debt is developing in France and, for some start-ups, may be an attractive and less dilutive option despite potentially high lending costs. In France, venture debt instruments are generally structured as notes associated with warrants, constituting an equity kicker. From a general standpoint, venture debt naturally imposes certain constraints on the borrower (relatively high interest rates, financial covenants, governance/reporting rights of the lenders such as an observer on the board, pledges on certain assets such as intellectual property assets). On the other hand, it is viewed as an alternative to avoid a massive dilution through a pure capital increase financing round. Venture debt may sometimes be used as a complement to classic equity financing rounds or as a bridge to try to postpone a downround. It should be noted that the European Investment Bank initiated a venture debt programme targeting only innovative companies having already completed one or two funding rounds with private investors.

Even if much more limited, equity crowdfunding could also be viewed in certain circumstances as a complementary tool in the financing armory of tech companies. In January 2024, Vestiaire Collective, for instance, launched a crowdfunding campaign with the aim of reaching profitability and potentially going public.

Outlook for VC Funds

It is anticipated that VC activity will remain unequal among sectors in 2025, with most funding likely focusing on AI and defence. A future further interest-rate cut could conceivably result in a rebound in fundraising levels in 2025, but a meaningful recovery (in value and volume) in these, in deals and in VC-backed IPOs seems unlikely in the very short term.

Current macroeconomic conditions may also result in an increase in disputes around earn-out/underperformance clauses which may have been stipulated in investment agreements between founders and investors.

Conversely, the challenging VC environment also creates opportunities for investors to conduct transactions on the basis of more reasonable valuations.

GERMANY

Law and Practice

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1. Trends

1.1 VC Market

In a structured transaction, global travel tech company Flix secured a minority investment from investment firm EQT and Kühne Holding, an investment vehicle of German logistics entrepreneur Klaus-Michael Kühne. The investment in Greyhound owner Flix was led by EQT's impact-driven, longer-hold fund EQT Future, and seeks to strengthen Flix's balance sheet. The aggregate investment was reported to total EUR1 billion.

Led by General Catalyst, German AI defence company Helsing reportedly raised EUR450 million in one of Germany's most sizeable equity funding rounds (Series C) in terms of volume in 2024. AI-driven language translator platform DeepL also secured EUR277 million in funding in May 2024 led by investor Index Ventures, raising the valuation of the Berlin-based company to approximately EUR1.85 billion and making it Germany's most valued pure-play AI start-up. Munich-based space-tech venture The Exploration Company secured a EUR150 million Series B round led by Balderton Capital and Plural, with participation from a selection of additional investors.

Other sectors with significant funding activity include software and analytics (Helsing, osapiens), health (eGym, CatalYm, Tubulis) and energy (sunfire, Enviria, 1Komma5°).

Interestingly, private debt played a significant role in various later-stage transactions in the German market, such as fintech SumUp, Enpal and iwoca – with the first two private credit transactions reportedly exceeding EUR1 billion in volume.

Notable M&A exits were few and far between for German start-ups in 2024. In May, Dedrone, a German drone defence company, was sold to Axon, a police equipment manufacturer from Arizona, for USD500 million. Another significant M&A exit in the health sector was Cardior, engaged in the development of RNA therapies for heart diseases, acquired by Novo Nordisk for about EUR1.025 billion. Berlin-based start-up Delphai, an AI venture specialised in natural language processing, was acquired by Intapp, a publicly traded company from the US.

In a depressed German market environment, only seven companies went public. Germany's largest IPO was the listing of Douglas in March 2024, with an issuance volume of almost USD1 billion, followed by Springer Nature with USD665

million. German 3D manufacturer BigRep's listing in the general standard of the Frankfurt Stock Exchange was among the very few in the growth sector (along with Steyr Motors and Elaris in the junior markets).

1.2 Key Trends

Overall Trends

The broader trend of increased cost of capital in Germany and challenged valuations is reflected in both financing round valuations and liquidity events. Overall, investors are opting for safer bets and prefer companies with a proven track record or alternative investments over very early-stage ventures.

Structured investments, comprising a mix of debt and equity, as well as primary and secondary transactions, were noticeably more present than in previous years, marking a trend towards bespoke funding events as opposed to more traditional equity financing rounds. Further, certain funding events that occurred in challenging conditions drew significant media attention – eg, air taxi start-up Lilium, or grocery delivery platform Flink.

The number of financing rounds declined for the third year in a row, falling by 12% to 755 transactions vs 2023. Compared with the record number from 2021 (1,160 deals), the number of financing rounds was down 35%. However, the total value of venture capital (VC) investments increased significantly compared to 2023 by more than EUR1 billion to just over EUR7 billion – the third-highest value in the past ten years.

At the same time, numerous growth companies are facing liquidity constraints, prompting some 336 start-ups to file for insolvency in 2024. This figure exceeds the number for the previous year and is 85% higher than in 2022. Prominent examples include fintech Creditshelf, which underwent protective shield proceedings (*Schutzschirmverfahren*), and relocation start-up Movinga, which had to cease business operations. On the other hand, the rescue of Instamotion, a platform for used cars, illustrated that insolvency proceedings may be a means to continue operations in certain cases.

Regional Divergence

Geographically, Berlin led with a total of 239 venture-backed financing rounds in 2024, significantly surpassing both Bavaria with 146 and North Rhine-Westphalia with 76 transactions.

That said, Bavarian start-ups secured more than EUR2.3 billion in venture funding and surpassed Berlin for the first time in terms of volume, which attracted approximately EUR2.2 billion. North Rhine-Westphalia almost tripled its funding total from EUR331 million to EUR951 million in 2024.

Investor-Friendly Deal Terms

As the VC market is only slowly recovering from moderate levels, companies continue to concede more investor-friendly deal terms. These include founder lock-ups, vesting, and liquidation preferences, as further outlined in **3.5 Investor Safeguards and 5.2 Securities**.

1.3 Key Industries

In line with the global trend, equity funding in German growth companies heavily favoured software and analytics (including AI) in 2024, with start-ups in the sector securing some EUR2.2 billion. The health sector, the second-largest in terms of total financing volume, realised a total volume of EUR958 million, more than twice as much as in the previous year. As a result of one sizeable transaction in September 2024 (eGym), the fitness segment accounts for EUR185 million with only two deals.

VC-backed exits have overall not concentrated on certain industries and remained subdued in 2024. Notably, there has been an increased exit activity in the healthcare sector in 2024 compared to 2023. The top five VC-backed exits by value in 2024 came from drug discovery (Cardior), application software (Invia Group), mobility (TIER) and business/productivity software (Aaron.ai and shyftplan).

2. Venture Capital Funds

2.1 Fund Structure

While Germany-incorporated VC funds do exist, neighbouring Luxembourg is more popular, with many sizeable Germany-focused VC investors due to its investor-friendly ecosystem, flexible corporate law and robust regulatory framework. When domiciled within Germany, the asset-managing GmbH & Co. KG (a partnership with a limited liability company as the general partner (GP)) tends to be the preferred structure, owing to its fiscal benefits – in particular, its tax transparency and exemption from trade tax obligations.

Structure

When structuring funds as a GmbH & Co. KG, the separation of management and fund is mandatory. The initiators, together with the investors, participate as limited partners (LPs) without any additional payment obligations (*Nachschusspflicht*).

The GmbH serving as the fund's GP is typically excluded from owning fund assets, and its involvement in fund management activities is limited for tax reasons. Instead, fund management responsibilities (day-to-day administration) are assigned to a managing limited liability company (*Kapitalverwaltungsgesellschaft*, or KVG) (the *"Managing LP"*).

Investors often receive co-decision rights through an investor advisory board, selected by the Managing LP from among significant investors. This advisory board typically oversees, among other things, deviations from predefined investment criteria and extensions to investment timelines.

An investment committee (IC) leads the decision-making process, using various approval methods such as unanimous voting or a points-based system to ensure alignment with the firm's investment objectives. This makes the IC the actual investment manager of the fund.

Standard Documentation

Limited partnership agreements cover key areas such as capital contributions, profit distributions, investment strategies, time horizons such as investment and liquidation periods and governance (including GP and Managing LP rights). The terms may be tailored to the specific needs of LPs through side letters, which qualify as amendments to the limited partnership agreement.

2.2 Fund Economics

The internationally established *"2 and 20"* fee model constitutes the default within the German VC industry.

Management Fees and Carried Interest

The management fee is an annual fee paid by the fund to the Managing LP for purposes of covering administrative expenses and typically ranges from 2-2.5% of committed capital. It is charged every year the fund is in operation.

Carried interest is the percentage of profits of an investment (typically 20%) allocable to the fund's Managing LP. The Managing LP is entitled to carried interest once the fund has returned

the invested capital and a minimum, annually compounding interest rate (typically 6-8% pa – the *"hurdle"* rate) (distribution waterfall). However, if carried interest is paid on a deal-by-deal basis or the Managing LP is otherwise entitled to advances on the carried interest, LPs typically demand so-called claw-back provisions to address timing disparities/true-ups – pursuant to which carry beneficiaries are required to reimburse LPs if the funds received by the Managing LP exceed targeted returns.

2.3 Fund Regulation

In Germany, the regulatory framework for funds (including VC funds) is established by the German Investment Code (*Kapitalanlagegesetzbuch*, or KAGB). For an entity to be recognised as an investment fund under the KAGB, it must meet certain structural criteria and be overseen by a licensed management company.

Investment funds in Germany are categorised into Undertakings for Collective Investment in Transferable Securities (UCITS) and Alternative Investment Funds (AIFs), which encompass all non-UCITS investment entities. VC funds typically fall under the category of Special-AIFs, which are closed-end funds accessible only to professional and semi-professional investors, excluding retail investors. It remains to be seen what impact, if any, the general rise in European Long-Term Investment Funds (ELTIFs) will have on the VC industry and the composition of a funds' limited partners.

The Managing LP in an AIF (in the form of a capital management company (KVG)) requires authorisation from the Federal Financial Supervisory Authority (*Bundesanstalt für Finanzdienstleistungsaufsicht*, or BaFin) to operate. The KAGB provides for simplified regulation for *"small"* AIF-KVGs managing Special-AIFs below certain asset management thresholds (which includes the fund structures relevant for VC investments). *"small"* AIF-KVG manages Special-AIFs with assets not exceeding either EUR100 million, including assets acquired through the use of leverage, or EUR500 million without leverage if there are no redemption rights for investors within five years of the fund's first investment. German VC-fund KVGs tend to qualify for the exemption, primarily due to their non-reliance on leverage and their average fund size not exceeding the EUR100 million threshold.

Such *"small"* AIF-KVGs are subject only to registration, reporting, and specific financial statement obligations, as well as audit requirements. Only AIFs structured as limited liability entities or partnerships, where the general partner possesses limited liability (eg, GmbH, AG, GmbH & Co. KG), are eligible for management under this framework.

2.4 Particularities

Government-Backed VC Funds

Government-backed VC funds receive significant public attention in Germany. The Growth Fund Germany (*Wachstumsfonds Deutschland*), which achieved its EUR1 billion target volume in 2023, is a fund-of-fund that invests in German and international VC funds. It is one of the largest German government-backed VC funds, with the government providing approximately EUR350 million alongside institutional investors, such as Allianz, Signal Iduna and BlackRock. It is coordinated by KfW Capital – the investment subsidiary of the government-affiliated KfW development bank. As of the end of 2024, the Growth Fund Germany has already committed more than half of its target volume (EUR567 million) to 29 VC funds.

Another government-backed investment vehicle with assets under management of EUR275 million is Coparion, launched by the European Recovery Program (ERP) Special Fund (mandated by the German Federal Ministry for Economic Affairs and Climate Action (*Bundesministerium für Wirtschaft und Klimaschutz*, or BMWK)) and the KfW bank. Coparion focuses on Series A, B and C financing rounds for technology companies with a financing volume of between EUR0.5 million and EUR8 million, with up to a total of EUR15 million per start-up. Coparion invests as a co-investor under the same conditions and usually with the same volume as a private investor, such as a business angel or VC fund.

Finally, the High-Tech-Gründerfonds does, unlike Coparion, independently provide seed-financing and is backed not only by the BMWK and KfW bank, but also by a consortium of German private corporations. It has over EUR2 billion in assets under management and focuses on tech start-ups with substantial growth potential.

Impact Investing and Corporate VC

Impact investing has continued as a theme within Germany's VC landscape, with a notable emphasis on decarbonisation. Cleantech/energy is a key area for impact funds. Examples include BonVenture in Munich, which supports social enterprises and start-ups across sectors such as education and renewable energy across Germany and Europe. Furthermore, the World Fund, headquartered in Berlin, invests in energy, food, manufacturing, buildings and mobility start-ups while Berlin-based Planet A focuses on greentech start-ups.

Corporate VC plays a prominent role in Germany's investment landscape, and DAX-listed companies such as Allianz X, SAP Sapphire and DB1 Ventures (Deutsche Börse Group's VC arm) entertain notable, sector-focused VC programmes.

Fund-of-Funds

A discernible trend towards increased fragmentation in private markets investments – particularly within VC funds – and extended average holding periods, has led to a noticeable upswing in fund-of-funds activity. This development derives from an increasing number of investors focusing on niche industries or emerging technologies, thus fostering a broader diversification across the VC landscape. The largest fund-of-funds operator in Germany is KfW Capital, with a volume of around EUR2.4 billion. KfW Capital invests across all phases and sectors in VC and venture debt funds with a focus on Germany.

Dual-Track Exit Strategy

VC funds tend to navigate the increasingly extended timeline by implementing dual-track exit strategies for their ventures. In a dual-track process, a company simultaneously (or sequentially) prepares for an IPO as well as a private M&A deal to maximise exit opportunities once market conditions are favourable. In 2024, the Flix transaction showed that private equity opportunities may provide a viable alternative to an IPO exit for late-stage enterprises with continued long-term growth aspirations.

3. Investments in Venture Capital Portfolio Companies

3.1 Due Diligence

Legal due diligence is usually conducted by the lead investor and includes a review of the company's capitalisation table and key corporate documents. The process focuses on material terms and encompasses tax considerations, prior financing arrangements, contractual foun-

dations for revenues, liabilities, employment terms, ongoing legal disputes, and IP rights. Financial due diligence centres on validating the completeness and accuracy of the company's assumptions underlying its business plan, books and records and financial statements. Business due diligence explores the overarching economic outlook of the target company, examining market trends, industry dynamics, growth opportunities, and revenue forecasts.

In some instances (and unlike under, for example, US standard form NVCA documentation), founders assume personal liability for the representations and warranties made in transaction agreements. This liability is generally limited to the lower of:

- the amount invested in the financing round; and
- a cap equal to one to three times their annual salary.

Representations tend to be subject to further restrictions such as *"tipping baskets"*. Unless an entire data room is deemed disclosed against the representations and warranties (which is market standard in German M&A practice), the company will table exceptions in a disclosure schedule, underpinning the critical role of management in the due diligence process.

3.2 Process

Timeline

It typically takes between three and six months to raise a Series B round and the timeline is affected by factors such as complexity of the business model, revenue potential, investor interest, legal set-up and macroeconomic conditions. In general, a preparation and planning phase (centred around Key Performance Indicators and financial information) and the negotiation of financing terms result in the entry into a non-binding term sheet or memorandum of understanding (MoU). Investors will conduct due diligence while, concurrently, long-form documentation such as subscription and shareholders agreements are negotiated. The process is typically significantly accelerated if the funding needs are covered by existing investors that have insights into the business due to (advisory) board representation and information rights.

Relationship Between the Parties

If a new investor enters the cap table, the role of existing investors in a financing round is typically limited in that they do not actively participate in or necessarily benefit from the results of the due diligence. That said, all investors' consents are typically required in order to amend the shareholders' agreement, which is the central document in most financing transactions.

In terms of process, existing investors (and even all investors in early-stage financings) may share legal counsel to streamline and accelerate negotiations. In more sizeable rounds or structured transactions that involve a secondary component (*"exit opportunity"*), however, it is standard market practice to carefully review the need/desire for separate legal counsel in light of prospectively (diverging) interests. Cost of counsel is less frequently charged to the company than is the case in many jurisdictions.

Governance discussions typically evolve around exit rights and reserved matters/veto rights for commercially relevant measures, such as capital increases or amendments to the articles of association (AoAs). With deviations from the *"one share, one vote"* principle rarely relevant in practice, the statutory default super-majority requirement of 75% for significant measures,

such as a new financing round, typically serves as an inflection point for discussions.

3.3 Investment Structure

Apart from common stock, typically earmarked for founders and initial investors, the following instruments are frequently observed in German VC transactions:

- Convertible loans serve as the primary *"pre-seed"*-type of funding instrument in the German VC market. SAFE (Simple Agreement for Future Equity) agreements (a financing instrument popularised by incubator Y Combinator in the US) do not offer investors any significant advantages over convertible loans and come up against legal challenges, such as uncertainty associated with the issuance of *"naked warrants"* in a German stock corporation (*Aktiengesellschaft*, or AG)/European company (*Societas Europaea*, or SE), and lack of viability of *"automatic"* conversion (since capital increases are not actioned by the management but require the explicit consent of the company's shareholders, by means of a formal resolution) cannot be addressed in a straightforward manner. As founders may, however, favour SAFEs over convertibles due to the absence of repayment claims and accruing interest, etc, practical needs may ultimately outweigh lingering legal uncertainties.
- Convertible loan agreements do not require notarisation if they are entered into not only by the lender and the company, represented by a managing director, but also by the shareholders. In contrast, if the convertible loan agreements have been concluded only by the lender and the company, but without the shareholders, then these agreements require a notarised shareholders' resolution authorising the managing director, as well as the corresponding registration of this authorisation resolution with the Commercial Register. The notarisation requirement arises when lenders are subject to mandatory conversion conditions or must comply with shareholders' agreements setting out relevant obligations (eg, drag-along rights).
- Preferred stock is a form of equity that includes specific rights or privileges not afforded to common stockholders typically by means of a company's shareholders' agreement. In Germany, (non-participating) liquidation preferences and weighted-average anti-dilution provisions are mostly negotiated as a means of downside protection, while cumulative dividends are typically not addressed.
- Multiple voting shares (so-called *"founders' shares/dual-class shares"*) are equity shares with voting rights of up to 10:1 introduced by the Future Financing Act (*Zukunftsfinanzierungsgesetz*). They are intended to help founders retain their influence on the company despite raising capital, and have yet to find broad-based adoption in the German start-up landscape.
- Virtual (employee) stock option plans (VSOPs), which embody cash-settled and contingent claims of the holder against the company, are widely utilised in the German market. They are considered more straightforward and flexible (and may entail tax benefits) when compared with physically settled stock options or shares held in escrow/subject to reverse vesting conditions. Restricted stock units (RSUs), performance shares and other instruments are less frequently encountered, although German corporate law in a GmbH conceptually permits significant flexibility.

3.4 Documentation

Although there are no universally accepted standard documents for financing rounds in Ger-

many, the most frequently observed key documentation includes:

- Investment and shareholders' agreement (*Beteiligungs- und Gesellschaftervereinbarung*): both agreements are either combined or entered into as separate contracts. The investment agreement outlines the primary investment amount and corresponding ownership stake purchased by each investor in the financing round. It specifies the form and timing of fund disbursement to the company; additionally, milestone agreements may be established, linking the release of investment tranches to the achievement of specific goals by the company. Typically, the shareholders' agreement covers governance matters – eg, board composition, shareholder majorities and exit rights (IPO, tag- and drag-along rights). Since the investment and shareholder's agreement, in addition to the obligation to carry out a capital increase, regularly includes provisions to share assignments, pre-emption rights, co-sale rights and obligations or vesting regulations, it does require notarisation in the case of start-ups operating as an Entrepreneurial Company (with limited liability (*Unternehmergesellschaft (haftungsbeschränkt*), or UG) or GmbH.
- Articles of association: the independent regulatory content of the AoAs is limited, as all essential agreements between founding shareholders and VC investors are typically addressed in the investment-and shareholders' agreement. Nonetheless, the articles remain a mandatory component of VC investment documentation, and are publicly filed with the commercial register. The AoAs are renegotiated and adopted in each financing round to align with the investor's participation and to ensure consistency with the shareholders' agreement. The resolution of the shareholders' meeting to amend the AoAs requires notarisation.
- Corporate resolutions, which are necessary for capital increases and the exclusion of existing shareholders' subscription rights, are resolved upon by the shareholders' meeting and need to be notarised (Section 55 of the Act on Limited Liability Companies (*Gesetz betreffend die Gesellschaften mit beschränkter Haftung*, or GmbHG)). By making use of authorised capital (Section 55a GmbHG), the shareholders can empower the management of the company in advance, under certain conditions and within certain limits, to decide on the increase of the share capital by issuing new shares to existing or new VC investors. This allows for the swift collection of additional equity when needed. The resolution requires a majority of 75% of the shareholders for a GmbH (75% of the capital represented for an AG).
- Preliminary documentation in an initial stage of a transaction includes non-disclosure agreements and term sheets/MoUs. Typical contents of a term sheet are agreements on the investment amount, the valuation of the start-up and investor rights (eg, veto rights and liquidation preference).

3.5 Investor Safeguards

Statutory subscription rights entitle existing shareholders (by default) to subscribe for a pro rata number of newly issued shares in any capital increase. Additional anti-dilution protection, notably in a down-round scenario, is implemented by providing (additional) subscription/pre-emption rights within the shareholders' agreement.

Around 50% of investors require anti-dilution clauses in early-stage investments. The most common form of anti-dilution protection is the

weighted-average method which calculates the subscription price in a subsequent down round as an average of the financing round the existing investor actually participated in and the valuation implied in the down round. Full-ratchet clauses, on the other hand, effectively ensure that investors maintain a relative shareholding equal to their initial investment value irrespective of the valuation underlying the down-round. Full-ratchet protection tends to be *"off market"*, and can only be secured in rare (distressed) circumstances. *"Pay-to-play clauses"*, which incentivise existing investors to participate in a new financing (down) round by granting them the economic rights, privileges, and obligations to which they agree during the previous financing round, are less commonly used in Germany than in the US market.

Liquidation preferences have evolved to become market standard and determine the order of payout in a liquidation event (or a deemed liquidation event, which typically includes exit scenarios). They entitle investors to receive a certain multiple (although the German market standard is 1x) of their investment or a specified preference amount before other shareholders receive any distributions. Recently, preferred amounts that annually accrue interest, payable in kind, have become evident in the German growth market, while participating liquidation preferences are still an anomaly. Remaining funds/assets are distributed proportionally – ie, on a pro rata basis. This preference can be structured as *"participating"* in the *"second step"* pro rata distribution or *"non-participating"*, with the latter being more frequently seen in later-stage enterprises. Unlike the non-participating liquidation preference, the participating liquidation preference is not limited to hedging against the negative scenario of an exit below expected value, but rather also serves to secure the investor a premium over their investment. Non-participating liquidation preference holders have the option to receive value on a per share *"as converted basis"* so that in an upside scenario pro rata allocation is the norm.

3.6 Corporate Governance

Since start-ups are typically structured as GmbHs, the shareholders' meeting has the authority to issue binding directives to the company's managing directors. The GmbH comes with no statutorily mandatory bodies other than the shareholders' meeting and its managing directors, but typically does set up an (advisory) board where investors are represented. Certain transactions will require the approval of the shareholders' meeting or the board prior to execution – whether by statutory law, AoAs or, most notably, shareholders' agreements. These reserved matters typically include amendments to the AoAs, alteration of the rights attached to or issuance of new shares/instruments, significant corporate transactions and changes in the capital structure of the company.

Shareholders' agreements often set out information rights to regular reporting which go beyond statutory information and inspection rights.

3.7 Contractual Protection

Fundamental guarantees granted to investors relating to existence, title, the absence of encumbrances and conflicts, etc, are all but ubiquitous in German market practice. In addition, business-related representations, notably concerning the company's financial statements/status and adequacy of IP assets, are increasingly frequent, particularly in late-stage financings. However, warranties do not typically extend to the business plan, as inherent risks remain with the investor as part of a VC investment's nature.

Investors generally confirm that they are authorised to enter into the investment agreement and fulfil the associated obligations, that they are eligible/accredited investors, and that the execution and fulfilment of the agreement do not conflict with other obligations.

Additionally, a venture often commits to specific operational covenants which may include obligations to:

- maintain adequate insurance coverage;
- comply with specific accounting principles; and
- adhere to predetermined financial ratios or liquidity levels.

They are also often sought to address investors' diligence findings.

By statutory default, legal consequences of a breach of representations and warranties amount to the restoration of the breached *"contractual guarantee"* and the payment of damages if restoration is impossible (in rem restitution, or *Naturalrestitution*). However, in many cases, immediate claims for monetary damages are excluded. The liability concept in an investment agreement will typically be limited to a cap and, besides the company, founders/key employees may stand behind the representations, typically within the confines of adequacy. Upon breach of a covenant, injunctions become relevant as an effective course of action against the defaulting contractual party. This is also the most relevant legal remedy relating to a shareholders' agreement.

4. Government Inducements

4.1 Subsidy Programmes

Among the most relevant government programmes directed at enhancing investments in German early-stage companies are the *"INVEST – Venture Capital Grant"*, the *"Venture Tech Growth Financing"* programme, and the *"ERP-EIF Facility"*.

INVEST – Venture Capital Grant

The BMWK supports investments by private investors or business angels in young innovative companies with grants for investors (acquisition grant of 15% of the invested amount). The investments can be made by natural persons or via an investment company. Natural persons can receive an exit grant if they sell their shares. The exit grant amounts to a flat rate of 25% of the capital gains realised, and thus approximately covers the tax burden associated with the divestiture. The maximum eligible investment amount per investment is EUR333,333.33 per single investment. Each natural person (as a direct investor or as a shareholder in an investment company) can be supported with INVEST up to a maximum total investment amount of EUR666,666.66 (also for investments in different companies) – ie, the acquisition grants per person are limited to a total of EUR100,000 (cap).

To apply, start-ups may submit an online application to the Federal Office for Economic Affairs and Export Control (*Bundesanstalt für Wirtschaft und Ausfuhrkontrolle*, or BAFA), providing details, including evidence of innovation, company size, age, and legal structure. Upon approval, BAFA issues an eligibility certificate. The investor can then apply for funding via BAFA prior to subscription for shares in the start-up or subscription for convertible bonds.

Venture Tech Growth Financing

The KfW's *"Venture Tech Growth Financing"* programme supports emerging technology-oriented companies through funding provided by the German federal government (via the KfW banking group). The programme is part of the Tech Growth Fund initiative. Financing is exclusively facilitated through collaboration with professional, private credit, or venture debt providers. KfW participates under identical terms as the corresponding private lender, sharing the risk, which usually ranges between EUR0.5 to EUR125 million. The standard risk-sharing ratio between KfW and private lenders stands at 50:50.

ERP-EIF Facility

The ERP-EIF Facility is a partnership between the German federal government and the European Investment Fund (EIF) aimed at bolstering venture and growth capital financing, in particular for high-tech growth companies in Germany. The facility's funding has been successively increased, and volume is currently EUR4.6 billion. The ERP-EIF Facility invests as a fund-of-funds and consists of four sub-programmes (ERP-EIF VC Funds of Funds, EAF Germany, ERP-EIF Growth Facility and ERP co-investment in GFF-EIF Growth Facility). With more than 4,000 small and medium-sized enterprise (SME) investments in Germany and across Europe, the ERP-EIF Facility covers all technology areas through supported funds and forms a relevant part of the pan-European VC ecosystem.

4.2 Tax Treatment

Direct Investment

Shares held by individual shareholders as non-business assets (Privatvermögen)

Capital gains from the sale and other disposals of shares which an individual shareholder holds as non-business assets (generally, participations below 1%) are generally subject to a 25% flat tax (plus 5.5% solidarity surcharge thereon, resulting in an aggregate withholding tax rate of 26.375% plus church tax, if applicable). Losses from the sale of shares may be subject to loss offset restrictions – eg, can only be used to offset capital gains or other investment income. The amount of the taxable capital gain from the sale is the difference between: (a) the proceeds from the sale; and (b) the cost of acquisition of the shares (including sale-related expenses).

Shares Held as Business Assets (Betriebsvermögen)

In respect of gains on the disposal and other disposals of shares held by an individual or corporation as business assets, taxation generally depends on whether the shareholder is a corporation, an individual or a partnership.

- For corporations, capital gains from the sale of shares are, as a general rule and currently irrespective of any holding period or percentage level of participation, effectively 95% exempt from corporate income tax (including solidarity surcharge) and trade tax plus solidarity surcharge.
- For individuals, 60% of capital gains from the sale of shares are taxed at the individual income tax rate plus a 5.5% solidarity surcharge (plus church tax and trade tax, if applicable) on such income tax if the shares are held as business assets by an individual who is subject to unlimited tax liability in Germany. All or part of the trade tax levied may be credited on a lump sum basis against the individual income tax.
- If the shareholder is a partnership, the individual income tax or corporate income tax is not levied at the level of the partnership but at the level of the respective partners. The taxation of each partner depends on whether they are a corporation or an individual. Thus,

(corporate) income tax (including solidarity surcharge) and, if applicable, church tax will be assessed and levied only at the level of the partners. Trade tax, however, is assessed and levied at the level of the partnership if the shares are attributable to the permanent establishment of a commercial business of the partnership in Germany. Generally, 60% of a capital gain attributable to an individual partner and 5% of a capital gain attributable to a corporate partner are taxable. The trade tax paid by the fund and attributable to the individual's general profit share is completely or partially credited against the partner's individual income tax in accordance with this lump-sum method (see above).

Foreign Tax Residents

Capital gains from disposals by a shareholder not tax resident in Germany are generally only taxable in Germany if the selling shareholder holds the shares through a permanent establishment or fixed place of business in Germany or as business assets for which a permanent representative is appointed in Germany. In this case, the description above for German tax resident shareholders who hold their shares as business assets applies accordingly.

Interposition of Funds

Typically, investments in growth and start-up companies are made in funds structured as partnerships, which tend to be tax-transparent structures if certain criteria are met. Simply put, merely managing one's own assets, regardless of size, is not considered a commercial activity. However, details are heavily disputed in practice, and whether or not tax transparency of the fund can be achieved requires a case-by-case analysis. If it is the case, then, due to the tax transparency of the fund, the above considerations regarding a direct investment in a portfolio company apply accordingly – ie, there is no difference as far as an investor is concerned. By contrast, if the fund qualifies as trading (*gewerblich*), it is subject to trade tax; the trade tax paid by the fund and attributable to the individual's general profit share is completely or partially credited against the shareholder's individual income tax in accordance with the lump-sum method (see above).

Carried Interest

Carried interest received by VC/private equity fund initiators (typically managing LPs) is, in case of a tax-transparent fund, subject to the partial income method – ie, only 60% is subject to tax at the marginal income tax rate of the carried interest participant. Political attempts to abolish this tax advantage for carried interest resulting from tax-transparent funds have been effectively resisted. It should, however, be noted that the tax treatment of the carried interest received by the initiators of a trading (*gewerblich*) fund is heavily disputed.

4.3 Government Endorsement

On 15 December 2023, the Future Financing Act came into effect. The objective of this legislative measure was to facilitate access to capital markets and equity financing for start-ups, growth companies and SMEs, in particular. This is to be achieved through, among others, digitisation, deregulation and internationalisation in the areas of capital markets law, corporate law, and tax law.

The Future Financing Act (re)-introduces dual-class shares for (later-stage) start-ups in the form of AGs/SEs, which signifies a significant shift driven by international competition within the capital markets. With several European countries now permitting multiple voting shares in public companies, this new legislation seeks

to dissuade German start-ups from opting for foreign legal structures solely for this reason, enabling founders to maintain control over a company, even after selling shares to investors or undergoing an IPO. Corporations are now permitted to issue registered shares with multiple voting rights (regardless of size or whether they are publicly traded). The super voting power must not exceed ten times the voting rights of *"ordinary"* shares. Unanimous shareholder consent is required to establish multiple voting shares, rendering their introduction at existing public companies more or less impracticable. The tenure of multiple voting rights terminates ten years after the company's IPO or inclusion in the regulated unofficial market (*Freiverkehr* Section 48 of the Stock Exchange Act, or *BörsenG*) (the so-called sunset clause). This timeframe can be extended by up to ten years via a resolution passed by three-quarters of shareholders. Multiple voting shares cannot be issued when utilising authorised capital.

The expansion of the allowable amount for a capital increase with simplified exclusion of (statutory) pre-emption rights as stipulated in the Future Financing Act will entail significant practical implications. Pre-emption rights may be waived for a capital increase against cash contributions, especially if the issue price is not considerably below the stock market price. Previously, the volume for capital increases with simplified exclusion of pre-emption rights was capped at 10% of share capital; this limit has now been elevated to 20%. Capital increases with simplified exclusion of pre-emption rights will be more attractive to issuers as legal recourse is significantly limited. Resolutions for such increases cannot be contested on the basis of allegations of an unreasonably low issue price. Shareholders excluded from pre-emption rights are not entitled to cash compensation under the German Stock Corporation Act (*Aktiengesetz*, or AktG).

The Future Financing Act also raises certain volume limits for a corporation's conditional capital. Conditional capital increases to finance stock options for management and employees can now be conducted up to 20% (previously 10%) of the share capital. This change is expected to impact start-ups where a significant portion of compensation may be provided in options.

The Future Financing Act stipulates a comprehensive overhaul to the legal protection mechanism for shareholders concerning capital measures approved by the general meeting. Due to the uncertainty of court decisions in connection with contestation litigation (*Anfechtungsklagen*) that alleged the inadequacy of the issue price (in instances where subscription rights were excluded), such contestation litigation posed risks of delays or non-implementation of capital increase resolutions. Under the new version of Section 255 AktG, resolutions can no longer be contested on the basis of the allegation that a shareholder sought to obtain special benefits or due to an allegedly unreasonably low exchange ratio (in case of a share contribution). Instead, it needs to be clarified in appraisal proceedings whether and to what extent the shareholders are entitled to a compensatory payment.

German Growth Opportunities Act (Wachstumschancengesetz)

In addition to the Future Financing Act, the German government aims to create incentives for more innovation and investment in new technologies through the German Growth Opportunities Act, in order to enhance the competitiveness of Germany as a business location. The act was passed by the *Bundestag* and *Bundesrat* on 22 March 2024, and includes a total volume

of EUR3.2 billion. Companies will benefit from expanded tax incentives for research, improved depreciation options, tax incentives for new residential construction, enhancements to tax loss deductions, and the introduction of electronic invoicing.

WIN Initiative: Growth and Innovation Capital for Germany

The WIN Initiative, presented to the public in November 2024, aims to further establish Germany as a leading location for innovation and growth capital by 2030. Together with a broad alliance of businesses, associations, politics, and the KfW, the federal government intends to sustainably improve the overall conditions for growth and innovation capital in Germany. The participating companies together plan to invest around EUR12 billion in the German VC ecosystem.

5. Employment Incentives

5.1 General

Founder/employee arrangements remain highly customised, taking into account various factors such as the negotiating leverage of the founding team, the complexity of the required structure, the specific incentives the company intends to offer, strength of desire for retention on the part of investors, tax considerations for employees, and the intricacy of technical implementation.

Founders typically hold physical shares without restrictions on voting or other membership rights. Generally, transfer restrictions are limited to rights attaching to other shares under the shareholders' agreement. However, in early-stage investment rounds, financial investors would typically require a renewal of the vesting schedule.

In respect of new hires, there are several forms of incentivisation for purposes of committing employees to the venture – eg, options to acquire company shares (stock options), participation via a VSOP, an employee stock ownership plan (ESOP) or so-called hurdle shares.

With the distribution of stock options, employees receive a (call) option to acquire company shares at a predefined exercise or strike price, provided certain conditions are met and the options are vested. Transfer restrictions for options are generally comprehensive and may further attach to the shares which are granted as part of a physical settlement.

Sometimes (untechnically) referred to as ESOPs, under *"reverse vesting"* scheme, the ownership of company shares is transferred to the employee. To ensure that the company is protected against fraudulent use or transfers, the power of disposal (*Vinkulierung*) and the rights of membership are restricted. In general, vesting conditions (so-called reverse vesting) are part of the mechanism and grant the company the option to claw back the equity granted in case of certain circumstances such as a leaver event.

VSOPs are designed to simulate the economics of a stock option while providing the advantage that no membership/governance rights attach to the instrument (pure cash settlement). VSOPs embody the right for a (deferred or contingent) cash payment claim if an exit event occurs. The payment amount is based on the (increase in the) company's fair market value since the date of grant. In complex transactions, the determination of the equity value underlying the transaction can be complex and prompt an acquirer to demand that settlement agreements be entered into.

In addition, a company may option for hurdle shares as means of incentivisation – ie, company shares with *"negative liquidation preference"* ensuring that employees only participate in future value increases. Hurdle shares are physical shares which may require an implementation of the negative liquidation preference as part of a company's (GmbH) articles.

5.2 Securities

Through participation programmes such as ESOP/VSOP, employees financially engage in the start-up's success via physical or virtual equity incentives. The exercise of the right is typically subject to several conditions – eg, duration of employment (vesting), performance of the company/employee or acquisition of the company.

Non-compete and non-solicitation agreements are widespread as part of shareholders' agreements. This is to safeguard the company's interests and prevent founders and key employees from engaging in competitive activities or soliciting customers, employees, or business partners upon leaving the venture.

Vesting conditions ensure that employees have only access to their shares after a certain period of time. This vesting period is typically between two and five years, with a one-year cliff vesting period. If employees depart before the end of the vesting period, they cannot exercise the unvested part of their stock option, nor do they receive payments from the unvested part of their VSOPs which are forfeited. Vesting conditions can be used for all of the previously mentioned instruments.

Additionally, employee participation programmes like ESOP/VSOP or hurdle shares may include good leaver/bad leaver clauses which permit the company to reclaim equity granted to an employee upon departure (typically, a reverse vesting call option at nominal value). Bad leaver qualifications tend to be limited to gross misconduct or criminal activity, as well as voluntarily terminations on the part of the employee – making Germany an instrument holder-friendly jurisdiction.

In practice, reverse vesting, which consists of the granting of a call option over the shares obtained in favour of the venture or the other shareholders, is often agreed upon for founder vesting. The founders are initially allocated their full shares and, at the end of the vesting period, all shares become vested and secured. However, premature departure from the company during the vesting period results in the loss of the unvested portion, potentially compensated for only partly or at a discount. The decision between a VSOP agreement with vesting or a submission of previously held founder shares to a reverse vesting mechanism should always be analysed from a tax perspective.

5.3 Taxation of Instruments

Tax-effective structuring of incentive schemes targets: (i) the avoidance of dry income events for an employee; and (ii) the receipt of capital gains tax treatment for any future increase in company valuation at a preferred tax rate of 25% (plus 5.5% solidarity surcharge thereon, resulting in an aggregate tax rate of 26.375% plus church tax, if applicable) (*"Capital Gains Tax"*).

ESOP

Almost all ESOP agreements stipulate that employees can acquire shares free of charge or at a discounted price which leads to a non-cash benefit (*geldwerter Vorteil*) and is, therefore, subject to income tax. However, a financial benefit in the form of a discount is only consid-

ered to accrue to the option holder as and when they exercise the option and acquire underlying shares at a discounted rate; only at this point is the monetary benefit realised and subject to taxation. As a result, employees are required to pay taxes on a non-cash sum, unless the time of exercise coincided with a liquidity event, potentially resulting in significant additional tax payments of up to 45% (plus a 5.5% solidarity surcharge thereon, resulting in an aggregate tax rate of 47.475% plus church tax, if applicable) in income tax on the benefit (dry income). Any capital gains from the increase of the value of the granted shareholding after the acquisition are subject to Capital Gains Tax.

VSOP

VSOPs do not entail dry income events as they are taxed upon the actual cash payment to the employee. However, VSOPs trigger a full taxation at a rate of up to 47.475% in income tax/solidary surcharge (plus church tax, if applicable), not offering any option to allocate at least part of the future increase in company value to Capital Gains Taxation.

Hurdle Shares

In order to overcome the disadvantages of the above instruments, hurdle shares have become increasingly popular in the German market. The envisaged tax treatment of hurdle shares is that the employee can acquire the shares for free/at a significant discount due to the *"negative liquidation preference"* attached to the shares. Notwithstanding the inherent *"option value"* of hurdle shares, the negative liquidation preference is designed to result in a low/no value of the shares granted to the employee and, thereby, ideally avoid a dry income taxation. Any future increase of the company's valuation is meant to permit Capital Gains Tax treatment. In this context, taxpayers often try to obtain a binding ruling for the desired tax treatment of hurdle shares which, however, has become increasingly difficult in the recent past. As a result, there remains a legal uncertainty with regard to the valuation of the negative liquidation preference.

Tax Revisions to ESOP Schemes (Physical Shares Subject to Reverse Vesting Provisions)

German tax law basically offers two benefits for the grant of physical company shares – ie, tax benefits only applicable to ESOPs, stock options and (likely) hurdle shares but not to VSOPs.

German tax law may, subject to the satisfaction of certain conditions, permit a deduction of up to EUR2,000 from the income resulting from the acquisition. In practice, this deduction is, due to this low amount, not important for the structuring of incentives.

More importantly, income tax resulting from the acquisition of discounted shares may be deferred until the occurrence of certain events (Section 19a of the German Income Tax Act (*Einkommensteuergesetz*, or EStG)). This may result in an avoidance of the dry income problem while enabling the employee to acquire the company shares at an early point in time so as to receive a preferential Capital Gains Tax treatment on the future increase of company value. This rule should generally also apply to Profit Participation Rights. However, this must be examined on a case-by-case basis, depending on the specific structure of this instrument.

The enhancements and a broadening of company eligibility criteria of Section 19a EStG under the Future Financing Act and the Fund Location Act (*Fondstandortgesetz*) led to a significant increase in incentive programmes under the regime of Section 19a EStG. Notably, the change

of employer or reaching of a minimum holding period of 15 years will no longer necessarily result in the termination of the tax deferral. As a result, tax is only due at the time when the company shares are actually sold by the employee, thereby avoiding the dry income problem. Since the amendment was introduced, shareholdings in any affiliate of the employer company (within the meaning of Section 18 AktG) are also subject to this benefit, which is of particular interest for foreign start-ups with subsidiaries in Germany.

To sum up, with the Future Financing and the Fund Location Act, the legislator successfully attempted to offset the competitive disadvantage that Germany faced compared to other jurisdictions such as the US. However, certain issues persist. For example, the provision (still) excludes later-stage companies despite its broadened eligibility criteria. Finally, social security contributions incurred at the time of acquisition are not deferred and fall due within the dry income window.

5.4 Implementation

From a process perspective, investment terms are typically outlined in non-binding term sheets, following an assessment of the market, team and an initial validation of the business model by investment teams. As due diligence progresses and binding documentation are entered into, investors in a round often sign and close their investments concurrently, contingent upon fulfilling conditions precedent. The *"option pool"* or VSOP – whether newly established or expanded upon (ie, the creation of additional awards within an existing pool or scheme) – would ordinarily take effect at the time of a financing round's closing or, in particular, if additional structuring work is required, may be implemented thereafter.

New investors generally expect growth companies in which they invest to increase or *"refresh"* the size of their employee equity incentive pool at the time of their investment. This becomes a key topic of negotiation because it is ultimately a commercial question with direct bearing on the company's valuation. As part of the key investment terms, existing shareholders and new investors will be required to find alignment on who bears the dilutive effects of an increase of the incentive pool or the (additional) number of instruments to be awarded. The point has been labelled *"option pool shuffle"* and concerns the questions as to whether the prospective dilution will be borne by existing shareholders only (and run against the pre-money valuation on a fully-diluted basis) or by all – ie, existing and new investors alike (in which case the increase in instruments runs against the fully-diluted post-money capitalisation).

When it comes to valuation and dilution, investors participating in a round will seek to have visibility regarding the amount of euros they are investing and what their investment amount translates into in terms of their fully diluted pro rata ownership in the foreseeable future. If the increased incentive pool were to be factored into the post-money valuations and all investors equally shared the dilutive effect, new investors would immediately be diluted after closing, and the relative stake purchased would require adjustment. Therefore, ESOP and similar increases are mostly counted against the pre-money capitalisation and are non-dilutive in respect of newly issued shares.

Discussions typically evolve around the substantiation of hiring and retention needs during a predefined timeline that the founding team will be incentivised to demonstrate in order to limit the size and, consequently, the dilutive effect of a pool increase and the new investors' argument

that equity-based incentives are the critical tool of aligning stakeholder interest in a start-up and therefore should be available in adequate quantum.

6. Exits

6.1 Investor Exit Rights

Share Transfer Restrictions

To safeguard existing shareholders, a GmbH's publicly available AoAs typically incorporate transfer restriction clauses (*Vinkulierung*), a violation of which will render a purported transfer null and void. These clauses reflect requirements set out in the shareholders' agreement and may either restrict the transfer of shares without the company's authorisation or bestow pre-emptive rights to existing shareholders or the company (redemption at a discount).

Pre-Emptive Rights/Right of First Refusal (ROFR)

A shareholder seeking to dispose of shares is under market standard shareholders' agreements obligated to offer its shares to shareholders (albeit not – as tends to be the case in other jurisdictions – the company) for their acquisition in proportion to their relative stakes in the company at the conditions offered by a third party within a specified acceptance period (*Andienungspflicht*). These rights tend to be structured as so-called *"Rights of First Refusal – ROFR"*, which permit existing shareholders to take *"last look"* and not only to put forth a price they would be willing to pay; this would then set the floor for a third-party transaction (so-called right of first offer).

Rights of first Refusal can be structured in a multi-stage process: (i) unless all existing shareholders have exercised their ROFR in a first round, those who did exercise their ROFR are entitled to acquire the residual (*"unexercised"*) shares in a second round, set within a specific timeframe; (ii) only if the ROFRs are not fully exercised for all shares subject to the sale in such second round, may the selling shareholder then proceed in a transaction with a third party, which sale would still be subject to existing co-sale rights.

Tag-Along Rights

Co-shareholders would typically have the right to demand from the selling shareholder that the sale be only carried out if their shares are (reflective of their pro rata stake in the company) sold alongside the selling shareholders' shares and subject to the same conditions. If the co-sale requirements are not complied with, there is no obligation to consent to the sale and the shares remain subject to existing transfer restrictions.

Drag-Along Rights

Co-shareholders may compel the sale of shares under predetermined conditions. Often, so-called drag-along rights are not confined to share deals, but extend to other exit routes, notably change-of-control transactions that take the form of mergers or the divestiture of substantially all assets (asset deal). However, share deals remain the most prevalent form of M&A transaction in the German marketplace and drag rights are primarily geared towards this situation.

While drag-along rights are usually contingent upon obtaining a qualified majority, there are occasionally drag sales granted as a unilateral option – eg, in scenarios where key milestones have not been met. Notwithstanding the contractual position, enforcement of drag rights in practice may be challenging and depend on management's willingness to endorse, or at least permit, an orderly sales process which may be

challenging in case of significant shareholder opposition.

Put/Call Options

In certain rare cases, strategically focused shareholders may succeed in negotiating call option rights over other shareholders' exiting stakes at a price that is typically reflective of, or based upon, a company's FMV, as existing at the time of the option window. Call options may permit a (group of) specific investor(s) to initiate a change-of-control transaction – eg, in the event of a significant strategic value for a corporate VC or if shareholders seek to pre-agree on a set *"path to liquidity"* after a certain time. Call option arrangements are often mirrored by corresponding put options and may entail a premium over, as well as a mechanism to fairly determine, the company's FMV.

IPO Force Right

A right by one VC investor to request that the company undertake preparations for an IPO/listing after a pre-defined period has been argued to conflict with the statutory authority of a management board of an AG/SE to act in the company's best interest, as existing from time to time. That said, IPO initiation rights are often structured so that all shareholders inter se commit to using their corporate governance rights to procure that an IPO will be initiated. These rights can be subject to value hurdles and/or timing requirements.

6.2 IPO Exits

IPO exits are typically driven by easier access to new capital, increased liquidity of the shares, a transparent valuation, improved branding and marketing for the company, and enhanced attractiveness to employees due to employee participation programmes. However, the predominant exit strategy in the current German market environment is an M&A exit, primarily by strategic buyers.

When publicly listing shares, issuers can choose from two market segments:

- the regulated market with higher admission and post-admission requirements leading to elevated transparency and typically greater liquidity; and
- the open market with lower entry and compliance costs, which may be more attractive for SMEs.

The Frankfurt Stock Exchange's Prime Standard is the sub-segment of the regulated market with the highest ongoing transparency requirements. Meanwhile, its Scale open market sub-segment is currently the only registered German SME Growth Market, which allows SMEs to make use of certain alleviations under applicable EU prospectus and market abuse rules.

In order to be admitted to the regulated market, the issuer is required to have been in existence for at least three years (subject to exemptions – eg, for special purpose acquisition companies (SPACs)), have sufficient free float, publish a prospectus including three years of audited financial statements, and report on a semi-annual (Prime Standard: quarterly) basis going forward.

An inclusion of securities in the open market is not governed by statutory law but, rather, the relevant market operator's general terms. Accordingly, the admission and post-admissions requirements vary more between markets – for example, with regard to admission documentation, requisite term of issuer's existence, free float and market capitalisation – and thus provide more flexibility for early-stage companies.

Uplistings from the open market to the regulated market are possible but not very common.

The preparation and execution of an IPO can be divided into three phases:

- Conception phase (between five and seven months): creation of the issuance concept, including investment case, placement volume and source (company vs shareholders), holding obligations (lock-up), use of proceeds, choice of market segment, and placement strategy/target investors.
- Implementation phase (between three and four months): preparation of investor presentations as well as the securities prospectus and application for BaFin approval. The prospectus is based on a comprehensive due diligence of the issuer by the global co-ordinators of the bank consortium.
- Placement phase (one month): underwriting agreement with the lead consortium bank(s), book building, and pricing. Trading usually commences one day and closes two days after pricing.

General economic conditions and capital market sentiments influence the timing. The issuer's IPO readiness is also critical, including factors such as financial performance, growth trajectory, corporate governance structure and regulatory compliance. As most start-ups in Germany are organised as a GmbH, the IPO tends to necessitate a structural conversion into a legal form suitable for public listings (AG, SE, or partnership limited by shares (*Kommanditgesellschaft auf Aktien*, or KGaA)).

Alternative capital market exit strategies to a traditional IPO involve:

- a direct listing, whereby the issuer's existing securities are admitted to trading without a concurrent public offering – sometimes a private placement with institutional investors is organised immediately prior to the listing; or
- a de-SPAC transaction, in which a private entity goes public by merging with a publicly listed SPAC.

6.3 Pre-IPO Liquidity

There is a tangible market need for pre-IPO secondary market trading, particularly to facilitate liquidity for certain investors and employees who hold equity-based compensation in privately held companies. However, so far, no relevant market structures have evolved in Germany or Europe. In Germany, the use of virtual instruments such as individualised, non-transferrable VSOPs has made it challenging for incentive entitlement holders to obtain meaningful liquidity.

In April 2024, Forge Global Holdings Inc., a leading private securities marketplace, together with Deutsche Börse, announced the launch of Forge Europe. Forge Europe seeks to establish a marketplace for direct secondary transactions in late stage/pre-IPO start-ups.

Pre-IPO secondary market trading faces certain legal challenges. Generally, a published securities prospectus is required for a public offer of shares (as further outlined in **7.1 Securities Offerings**). Given that most start-ups are organised in the form of a GmbH, a prospectus is not required, as a GmbH share is not a security within the meaning of the EU Prospectus Regulation.

Pursuant to Section 6 of the German Asset Investment Act (*Vermögensanlagegesetz*, or VermAnlG), the public offer of investments (which encompasses GmbH shares) requires the publication of a prospectus. Exceptions are made

in Section 2 paragraph 1 VermAnlG. No prospectus is needed, inter alia, if: (i) there is only a low distribution of the investment (maximum of 20 shares); (ii) the sales price of the investment offered within a period of 12 months does not exceed a total of EUR100,000; or (iii) the sales price of the investment amounts to at least EUR200,000 per investor.

Determining the fair market value of privately-held company shares (or virtual instruments) for secondary market transactions can be challenging due to the absence of publicly available pricing data and market benchmarks. As there is a shortage of investors facing a significant number of potential investment targets, an information asymmetry persists on the buy-side.

Shareholders' Agreements tend to stipulate various share transfer rights and restrictions such as ROFRs, ROFOs, co-sale and tag-along rights which apply in respect of secondary transactions and can complicate, or even block, trade sale transactions.

It remains to be seen how well transfer restrictions in German market practise and the continued use of virtual instruments permit an evolution of secondary trading and whether shareholder agreements will pre-clear certain transactions relating to vested shares in late-stage companies.

7. Regulation

7.1 Securities Offerings

For an AG/SE/KGaA, in the event of a sizeable transaction such as a capital increase with no (statutory) pre-emptive rights, a prospectus is not required in the case of a public offer if the offer is exclusively directed to qualified investors (who are deemed to have sufficient sources of information to obtain the necessary basis of knowledge). If a public offer targets non-qualified investors, a prospectus is not required if it is addressed to fewer than 150 natural or legal persons.

The public offer of GmbH shares does not require the publication of a prospectus under the VermAnlG if the offer is addressed to a limited number of persons or it is addressed only to employees by their employer or by an affiliate of their employer.

If numerous employees/entitlement holders exist in a (late-stage) start-up organised as an AG, the transferability of shares is usually largely restricted. Consequently, in such cases, these shares do not qualify as securities under the EU Prospectus Regulation. Even in instances where transferability is not restricted, a prospectus is not mandatory if a document is provided containing information about the quantity and characteristics of the securities, as well as the reasons and particulars of the offer.

7.2 Restrictions

Foreign Direct Investment Screening (FDI)

The German foreign investment screening framework is governed by the Foreign Trade and Payments Act (*Außenwirtschaftsgesetz*) and the Foreign Trade and Payments Regulation (*Außenwirtschaftsverordnung*). The competent authority, the BMWK, has the authority to examine whether the investment in a domestic company through the direct or indirect acquisition of voting rights is expected to negatively affect the public security or order of Germany, another EU member state or with respect to projects of EU interest.

As part of the cross-sector regime (*sektorübergreifendes Verfahren*), the law currently lists 27 categories (including critical infrastructure in a number of sectors and other business activities in many different areas, such as software, healthcare, artificial intelligence, semiconductors and others) where the acquisition by a non-EU investor requires a mandatory filing and prior clearance by the BMWK. Voting rights thresholds of 10% or 20% apply – depending on the applicable category. In case the German company is active in certain areas of military, defence or security of government information technology, acquisitions by non-German investors of 10% or more of the voting rights trigger a mandatory filing and pre-closing clearance requirement as part of the sector-specific regime (*sektorspezifisches Verfahren*). In all other cases, the BMWK is entitled to review any acquisition by non-EU investors of at least 25% of the voting rights, even if no mandatory FDI filing is required.

For an investor who already owns a participation above the entry thresholds, the crossing of certain further thresholds may require prior clearance (20%, 25%, 40%, 50% and 75%). Pursuant to guidance from the BMWK, the acquisition of additional voting rights as part of capital increases or financing rounds is only covered by the German FDI regime if the percentage share of voting rights crosses a relevant threshold as a result of the transaction (ie, not if an investor acquires shares only to the extent required to prevent a dilutive effect).

Foreign investment approvals have become increasingly significant in the realm of VC and start-up investing, as the German regime was amended several times during the past few years to cover a broader range of activities without regard to the size of the business. At the same time, almost half of the VC funds invested in Germany derive from third countries, according to reports of the German Start-up Association (*Bundesverband Deutsche Startupse.V.*).

The European Commission is currently working on a comprehensive revision of the legal framework with the objective to instigate a dedicated investment screening law in all EU member states.

Investments in Regulated Banks, Financial or Payment Services Providers and Insurance Companies

In the fintech/insurtech space, an investor that intends to acquire a direct or indirect participation in a German regulated bank or other financial institution – such as a financial services provider, payment services provider, e-money institution or investment firm – of over 10% of the capital or voting rights is required to submit a notification to BaFin and obtain pre-closing approval in the context of an owner control procedure (*Inhaberkontrollverfahren*). During this procedure, BaFin reviews, among other things, the strategic plans, financial standing and reliability of the investor. The legal basis depends on the company's regulatory status. Crossing of 20%, 30% and 50% thresholds requires additional clearances. In the case of German banks that fall under European banking supervision, the approval process involves the European Central Bank.

An owner control approval is also required for direct and indirect investments in insurance and reinsurance undertakings as well as in certain regulated asset (fund) management companies – in each case, also starting at 10% of the capital or voting rights.

Stamp Duties and Currency Control

The German government imposes no stamp duties nor any control on the purchase or sale of foreign currencies.

Trends and Developments

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Strategic Realignment and Emerging Confidence

Germany's venture capital (VC) landscape has transitioned from hypergrowth to a more disciplined and sector-focused ecosystem. Following a period of market correction beginning in mid-2022, investors and founders are recalibrating toward capital efficiency, long-term sustainability, and strategic innovation, particularly in areas such as artificial intelligence (AI), green tech, and, more recently, defence tech. Despite macroeconomic pressures and geopolitical instability, and against a backdrop of evolving regulatory landscapes, Germany remains one of the most attractive VC destinations in Europe. The slowdown in funding has not hurt innovation, but resulted in a shift in mindset – ie, profitability over growth, efficiency over expansion, measured risk over speculative hype. This overview explores some of the key trends shaping Germany's VC landscape as we move through 2025, including sectoral shifts, legal and tax developments, the use of convertible instruments such as SAFEs, the emergence of defence tech, and the integration of AI into the VC process.

The German VC market at a glance

The German VC market remains in a period of transition. According to the EY Startup Barometer 2024, Germany saw a 12% increase in the number of startup financing rounds in 2023 compared to 2022, but total investment volume declined by 25% in the same period. This divergence appears to reflect the shift from growth-at-all-costs strategies to a more conservative, fundamentals-based approach. Median round sizes fell across Series A through C, with late-stage deals seeing the sharpest drops in valuation. Internal bridge rounds, often using convertible instruments, became more prevalent as startups tried to avoid down rounds or unfavourable valuations. In the course of 2024, the market reset showed signs of stabilisation, with cautious optimism emerging early in the year on sector-specific growth in areas such as AI-based business models, cybersecurity, space and defence tech. According to EY investment activity figures for 2024, while the number of startup financing rounds in the year fell by 12% compared to 2023, total investment volume increased by 17%, indicating that average round sizes are back on an upward trajectory.

German start-ups raised approximately EUR7.6 billion in 2024, making Germany the third-largest VC market in Europe, according to Crunchbase News. This accounts for about 15% of the continent's total funding, closely following France's

EUR7.9 billion (with the UK leading at EUR17 billion).

Germany continues to attract robust cross-border investment. US and UK-based VCs have remained highly active in Series B and later rounds of German start-ups. Over 30% of all deals with an overall round size larger than EUR10 million involved at least one non-European fund. Strategic and corporate VCs, including multinationals and sovereign wealth funds, have boosted exposure to German deep-tech and industrial automation start-ups. Berlin, Munich, and Hamburg remain leading start-up hubs, with the Bavarian capital, in particular, vying to produce more *"Municorns"* in the short term, but emerging centres such as Leipzig and Karlsruhe also growing, driven by university spinouts, public co-investment programmes and regional accelerator ecosystems.

How the recent introduction of substantial and across-the-board tariffs by the US administration might impact German start-up companies – that have benefitted from access to the US both as a source of capital and as a significant market for their goods and services – remains to be seen. While this development may lead some European founders to start their businesses in the US, the option to *"flip"* existing, more mature companies to the US comes with substantial complexity, ranging from corporate law and taxation to immigration issues. The more likely response to the emerging new trade policy framework by German start-ups might therefore be to focus on the domestic European markets and seeking to expand sales into other world regions. Companies offering services, rather than producing or delivering goods, are less affected by tariffs. This will apply to a significant number of companies within the German community.

Sectoral focus

Germany's start-up segment has seen a decisive shift in sector preferences. While generalist, sector-agnostic investing was common during the boom years of 2020–2021, investors are now showing a clear sectoral bias toward technologies with long-term value creation, strong IP protection, or strategic relevance. AI, climate tech, and defence tech have emerged as the leading verticals, closely followed by fintech infrastructure, biotech, and deep-tech hardware. Germany's leadership in applied sciences, engineering and industrial tech provides a strong foundation for these sectors.

AI startups: centre stage in 2024–2025

AI remains Germany's most dynamic VC vertical. The launch of OpenAI's ChatGPT-4 has triggered a global rush for AI capability – with Germany no exception. Homegrown start-ups such as Aleph Alpha (USD500 million raised in 2023), Brighter AI, Nyonic, and Cologne-based AI translation company DeepL are leading the charge in language models, data privacy tools, and ethical AI. Germany's AI landscape benefits from a combination of strong academic institutions, applied research, increasing public awareness and public funding support, and some 500 AI-focused start-ups are headquartered in the country. AI is no longer just a vertical – it is a cross-cutting enabler for SaaS, healthtech, biotech, logistics, fintech and industrial automation. According to figures from the German public bank KfW, AI-related start-ups accounted for 25% of Germany's early-stage VC volume in 2024, slightly below the 30% share observed in late 2023. Spurred further by the most recent mega-round of OpenAI announced in early April, in which the company took in another USD40 billion of fresh money – approximately one-third of the overall amount of global start-up investments in the first quarter of 2025 – resulting in a post-money valu-

ation of around USD300 billion, AI investments will likely continue to occupy centre stage in the VC universe as the year progresses.

Climate tech and green energy

The EU Green Deal and Germany's energy transition targets have been fuelling VC interest in cleantech and climate change mitigation technologies for some time. Key areas of investment include energy storage, battery technologies, charging solutions for EVs, grid optimisation, hydrogen electrolysis, carbon accounting platforms, and circular economy models. In 2023 and 2024 combined, climate tech raised some EUR3 billion in Germany, with notable deals including 1KOMMA5° (solar platform), Enpal (solar panel and heat pump installation), Heliatek (solar panel solutions) and Sunfire (green hydrogen). Investors are looking for capital-efficient, scalable technologies that can survive regulatory shifts and commoditisation pressure. Hardware-heavy start-ups are increasingly pairing VC with public grants, particularly from the European Innovation Council and German KfW programmes.

The emergence of defence tech

Previously an overlooked sector in European VC that also seemed at odds with many investors' ESG targets or investment restrictions, defence tech is experiencing a significant shift in perception and venture firms are now cautiously navigating this space, balancing ethical diligence with a growing interest in autonomy, cyber defence and surveillance systems. Russia's full-scale invasion of Ukraine, NATO readiness and interoperability goals, and EU strategic autonomy debates have all catalysed attention toward dual-use technologies. Start-ups such as Helsing AI (EUR209 million round co-led by General Catalyst and Spotify's Daniel Ek) and ARX Robotics are developing AI-enabled defence platforms, surveillance tools, and unmanned systems. While ethical debates remain, the German *Bundeswehr* and various defence accelerators have opened new channels for start-up procurement and public-private partnership. This space is expected to grow, fuelled further by the recent constitutional amendment in Germany partially lifting debt limitations for defence-related spending, albeit with scrutiny over export control and ethical AI concerns.

Fintech, biotech, and deep tech

Fintech investment has somewhat cooled, particularly for consumer-facing neobanks and *"Buy Now, Pay Later"* models. Instead, investors, as well as incumbent financial institutions through their Corporate VC activities, are focusing on backing B2B infrastructure providers, regtech, and embedded finance start-ups. Biotech remains strong, supported by Germany's life sciences clusters in Heidelberg, Berlin, Dresden and Munich. Noteworthy trends include personalised diagnostics, RNA platforms, and cell therapy, often integrating AI-based tools into the business model. Deep-tech hardware – including quantum computing, photonics, and chip design – has seen selective support, often blended with public subsidies or corporate VC. Notable players include IQM Quantum, Semron, and Marvel Fusion.

Convertible instruments and the rise of SAFEs

Convertible instruments, mainly convertible loans and increasingly also US-style Simple Agreements for Future Equity (SAFEs), remain very popular in Germany's early-stage start-up scene. These largely standardised instruments allow start-ups to raise capital without setting a valuation by deferring the pricing event to a future equity round, making them attractive in times of market uncertainty. The use of SAFEs in

Germany remains legally ambiguous. Under German GAAP and commercial law, SAFEs may not clearly qualify as debt or equity, creating classification problems for both founders and investors. Some German tax authorities consider SAFEs a form of debt instrument, while others treat them more akin to advance payments or options. The lack of binding legal precedent has led to diverging practices in documentation, accounting, and tax filings. As a result, structured hybrid SAFEs have emerged in the German market that incorporate certain investor protections common to convertible loans such as valuation caps, pro rata rights, board observers, and veto rights on key matters. Nonetheless, the use of SAFEs has expanded overall, particularly in angel and pre-seed rounds, where speed and simplicity are critical.

Convertible loans remain a widely accepted financing tool, particularly for bridge financing between priced equity rounds. These instruments are better understood under local law and offer similar benefits with clearer accounting treatment. Most convertible loans convert at a discount (typically 10–25%) in the next financing round and often include valuation caps or most-favoured-nation clauses. They may also be structured with investor approval rights, governance covenants, and redemption triggers in the event of non-conversion. While there had been some uncertainty around formal requirements following a recent decision of a higher regional court, market practice has adapted, and standard term documentation has been refined.

There is also continued uncertainty around the tax treatment of convertible instruments such SAFEs and convertible loans. Some SAFEs may trigger tax liabilities depending on their structure, particularly when tied to put options or deemed interest mechanisms.

Legal developments and documentation trends

Deal documentation in Germany has evolved in response to the changing funding environment. In the growth years leading up to 2021, with high competition between investors for participations in funding rounds, deal terms were often founder-friendly, with limited due diligence and standardised terms. Today, investor protections and thorough diligence efforts are back in focus. Term sheets now sometimes feature multiple (eg, 1.5x or 2x) non-participating liquidation preferences, milestone-based tranches, anti-dilution protection (full ratchet in some cases), and enhanced information rights.

Legal documents in the VC space have traditionally been less standardised than in the US or the UK, for example, where templates issued and annotated by the National Venture Capital Association and the British Venture Capital Association, respectively, are widely used. While the German VC market has also seen deal terms converge fairly significantly as it has matured, the lack of authoritative templates and precedents continues to trigger discussions around governance, vesting terms, reps and warranties and other items in early-stage equity rounds. This, together with the strict formalities around deal execution and procedural bottlenecks – including document notarisation, KYC formalities and local banking compliance – can create frustration for international investors doing deals in Germany. This lack of alignment increases transaction costs and prolongs negotiations. In recent years, there have been various attempts by stakeholders in the VC and legal communities to reach a more formal consensus on deal terms and to provide standard-form documents to the VC community. These efforts are ongoing and, coupled with advances in document automation

and legal tech, can be expected to enhance efficiency in VC deal making in future.

Employee incentive schemes – the quest continues

Germany's start-up segment has long struggled with comparatively unattractive tax rules for employee equity participation schemes. Historically, employees receiving shares would be taxed at the time of grant – regardless of liquidity – resulting in the infamous *"dry income"* tax burdens that rendered equity packages impractical. This placed German start-ups at a structural disadvantage compared to peers in the UK, France, or the US, where stock options and similar instruments are often tax-deferred or more lightly taxed.

While first attempts of a reform have already been introduced in 2021, its practical impact had been limited due to strict eligibility criteria and low effectiveness in mitigating the dry-income-effect. In January 2024, Germany introduced long-awaited changes to the taxation of employee equity participation schemes aimed at relaxing the eligibility criteria and increasing the effectiveness of the available taxation relief. Under the new regime, taxation on qualifying employee share grants can be deferred until a liquidity event, such as a sale or IPO, occurs. Only the deferred tax burden, based on the value of the allocated shares at the point in time of the grant, is subject to the employee's personal income tax, while the additional accrued value realised in the liquidity event is taxed at a flat capital gains rate of approximately 27.5%. The eligibility criteria were expanded to cover a broader range of companies. Companies must have fewer than 250 employees, less than EUR50 million in turnover and assets of less than EUR43 million at the time of the grant or in any of the six calendar years prior to the grant. At the time of the grant the company must be less than 20 years old.

The German start-up ecosystem has called for additional reforms to expand ESOP eligibility and simplify compliance. Uncertainties and costs around determining applicable valuations at grant and structuring complexities where companies wish to roll out ESOP schemes with real shares to a larger number of employees while keeping their cap table manageable often result in the need for pooling arrangements or Management Companies as intermediaries. Moreover, leaver cases trigger taxation and thus require additional structuring or workarounds.

As a result of these developments, the current German start-up landscape displays a mixed pattern of tools and approaches to employee incentive schemes. In light of the perceived shortcomings of the recent reforms relating to real equity grants, many companies still rely on virtual participation schemes (phantom shares or *"VSOPs"*), which do not grant actual equity and are more flexible in structuring and administration, but lack the alignment incentives and tax advantages of real equity. Some market participants have pushed for hybrid instruments such as profit participation rights (*Genussrechte*), to be able to combine the tax advantages of real shares provided by the new rules with the easy and cost-efficient administration applicable to virtual instruments. As things stand now, the *"golden formula"* for employee incentive schemes in Germany has not yet been found, so the dialogue on this topic between market participants, tax authorities and regulators is set to continue.

The role of AI in VC operations

While AI remains a dominant investment theme in Germany's VC landscape, it is increasingly

being adopted also within the venture capital process itself. Firms are deploying AI tools for automated deal sourcing, competitor benchmarking, legal document analysis, and portfolio monitoring. Natural language processing (NLP) tools, for instance, are used to process large volumes of pitch decks, contracts, and market reports – helping investment teams flag risks, identify opportunities, and accelerate decision-making processes. Predictive analytics are also used to evaluate start-up health based on indicators such as cash burn, team dynamics, hiring trends and market signals.

The growing adoption of AI in VC operations raises critical legal and regulatory issues as well as ethical questions. The EU AI Act, expected to take effect in phases from 2026, will classify AI systems into risk categories: unacceptable risk, high risk, limited risk, and minimal risk. Depending on the classification, AI systems will be subject to mandatory requirements such as transparency obligations, data governance audits, and human oversight. VC firms using AI internally will need to ensure that these tools meet relevant standards – especially if they involve automated decision-making or personal data analysis. High-risk applications may include AI systems that assess founders, evaluate creditworthiness, or process personal employment information as part of the diligence process.

Moreover, AI-based VC tools often intersect with data privacy regimes, particularly the GDPR. Automated processing of personal data – even in a commercial diligence setting – triggers heightened compliance obligations, including data minimisation, lawful basis assessment, and data subject rights management. Firms must establish internal policies to manage how data is sourced, stored, and used by AI tools. Some firms are developing internal AI ethics committees and adopting cross-functional governance structures to evaluate the risks and benefits of AI adoption. These frameworks will likely become standard in VC firms operating in regulated sectors or working with sensitive datasets.

The GP perspective

Fundraising

In 2024, German VC general partners (GPs) faced a challenging fundraising environment marked by several key factors.

- Recent fund returns have, in some cases, fallen behind expectations, making it harder for GPs to attract investors. Many funds from the 2020–2021 boom have yet to deliver significant value, leading to fewer distributions for limited partners (LPs). This underperformance leaves LPs hesitant to commit to new funds.
- The exit environment is constrained, directly curtailing the ability of LPs to recycle capital into new funds. With fewer IPOs and exits, longer holding periods and the rise of continuation funds, the liquidity for LPs is reduced. Lower distributions from prior fund investments make LPs less inclined to invest in new funds.
- Higher interest rates have altered the fundraising landscape. With central banks raising rates, safe assets now offer attractive yields, creating competition for LP capital. Institutional LPs are rebalancing portfolios away from illiquid venture funds and into lower-risk, higher-yielding asset classes. German GPs must therefore make a stronger case that their funds can outperform these alternatives.

Emergence of sector-specific and thematic funds

Recent years have also seen the emergence of highly specialised VC funds targeting sectors such as climate tech, industrial automation, digi-

tal health, and AI infrastructure. These funds are often formed by spinouts from established platforms or as GP-led vehicles backed by strategic corporate investors. Examples include deep-tech-focused UVC Partners, the BMW i Ventures model, and sectoral initiatives anchored by Fraunhofer, Helmholtz or other research institutions. LPs are increasingly drawn to these funds because of their domain-specific diligence models and proximity to industrial applications.

Succession

Succession within established GP teams presents another challenge from a legal, tax and commercial perspective. The German VC market is mature enough for many first-generation fund managers to be at or close to retirement age, raising concerns about leadership transition. Some top German firms have begun proactive succession planning to reassure investors, promoting younger partners to GP and spreading carry more evenly. This succession process often comes with internal financial pressure in raising funds, particularly around required *"team commitment"*. It is standard for VC GPs to commit their own capital (often around 1–3% of the fund) to align interests. These GP commitments have become substantial in absolute terms, posing a hurdle for younger partners, who often struggle to finance their share as they have not accumulated sufficient returns from earlier funds. Some firms now turn to creative solutions, allowing LPs to invest into the GP to generate the funds necessary for the team commitment or GP commitment loans.

Conclusion and Outlook for 2025

The German venture capital market in 2025 is best described as cautious, sector-focused, and more structurally mature. Investors are prioritising capital efficiency, governance, and alignment with long-term value creation. Founders are adapting to the new reality of lower valuations and longer fundraising cycles, but the community remains dynamic. Regulatory – and cultural – reform, particularly around tax and corporate law, will be critical to maintaining Germany's position as a top-tier destination for innovation funding, particularly in light of the substantial investments into domestic infrastructure and digitisation, which are on the agenda of the new federal government. Sectors such as AI, climate tech, defence tech, and industrial automation are expected to lead investment activity.

To ensure continued competitiveness of the German VC space, stakeholders are calling for further legal and regulatory improvements. These include simplifying tax treatment of SAFEs and other convertible instruments, expanding eligibility for tax-deferred equity schemes, and aligning start-up-friendly documentation standards. Additionally, German regulators may need to provide interpretive guidance on how emerging EU legislation – including the AI Act, Data Act, and Cyber Resilience Act – applies to start-up business models and investor operations.

INDIA

Law and Practice

Contributed by:
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JSA Advocates and Solicitors is a prominent venture capital advisory law firm in India, renowned for its innovative and client-centric approach. It partners with major Indian businesses and international corporations across diverse sectors. Specialising in seamless venture capital transactions, JSA collaborates closely with in-house legal teams, investment firms and financial advisers. The firm's nationwide practice structure consists of expert lawyers and offices in key locations, offering cost-effective services. JSA manages various venture capital deals, including funding rounds, acquisitions, exits, and restructurings. Its sector-specific expertise ensures a deep understanding of industry challenges, delivering tailored solutions. With over 30 years of experience, JSA expertly handles regulatory, economic and transactional complexities. Offering end-to-end services, JSA supports clients with structuring, due diligence and drafting agreements, and represents them before relevant authorities. Its integrated approach guarantees clients receive comprehensive advice throughout the investment process.

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1. Trends

1.1 VC Market

Venture capital transactions showed huge growth in 2024, rising substantially on a year-on-year growth basis. As a result, venture capital deal activity in India showed an uptick trend. This will be good for India in maintaining its position as a favourable venture capital transactions market. Good quality companies, founders and sectors attracted substantial funding from venture capital funds. To add to this, India's robust public capital markets encouraged companies to successfully raise huge public funds and attractive returns to investors who exited in the IPO. Several sectors attracted VC funding. The prominent ones include quick commerce, software, consumer technology, consumer retail, fintech, deep tech, EV and EV infrastructure-related companies. These new age companies outpaced fund raising as compared to the more traditional ones.

As per Bain & Co, India Venture Capital Report 2025, some notable deals of 2024 for primary investments include Zepto, Meesho, Lenskart, Rapido, Rebel Foods, Physic Wallah and Oyo. As per the same report, some notable exits include exits of investors in Policy Bazaar, Paytm, Mamaearth, Indigo Paints and Prataap Snacks. Companies that went public through IPOs include Swiggy, Ola Electric, Awfis, Travel Boutique and Suraksha Diagnostic.

1.2 Key Trends

A major announcement in the Union Budget of 2024 abolished the controversial angel tax for all classes of investors. This tax was levied on the premium paid on issuance of shares by investee companies. This is a welcome move, which is expected to boost venture capital deal making. Another major reform is the reduction in long-term capital gains on unlisted shares, from 20% to 12.5%. This will lessen the tax burden on the selling shareholders, thus resulting in investors earning a better rate of return on exit. These reforms, along with a more liberal regulatory regime, are expected to give momentum to venture capital investments. It is expected that VC funding will go deeper into tier 2 and 3 cities, such as in the hospitality sector and tourism-related industries.

1.3 Key Industries

The sectors/industries which attracted venture capital in the last 12 months include e-commerce and quick commerce, fintech, health tech, EVs and EV infrastructure-related companies, edtech, financial services, consumer tech companies, consumer retail, software, shipping and logistics. Many consumer technology companies raised funding through IPOs. As far as exits are concerned, most exits were seen in the fintech and consumer retail sectors.

2. Venture Capital Funds

2.1 Fund Structure

Venture capital vehicles used for investments are generally set up as a company, trust or limited liability partnership. Venture capital investment can be made in the form of (i) foreign investment; or (ii) domestic investment. Different provisions apply to these investments, as provided below.

Foreign Investment

For foreign investment, several routes are available to make the investment. The common form of investment is foreign direct investment (FDI), foreign portfolio investment (FPI) and foreign venture capital investment (FVCI), as described below.

FDI

FDI can be made by any person resident outside India but only in permitted sectors in India. Currently, FDI is allowed in most sectors. FDI can be made under (i) Automatic Route (ie, no approval of the government of India is required to make FDI); and (ii) Government Approval Route (ie, prior approval of the government of India is required).

Irrespective of the sector in which investment is made, if FDI is made (i) by an entity of a country sharing land border with India; or (ii) where the beneficial owner of an investment into India is situated in or is a citizen of any country sharing land border with India, FDI can only be made under the government approval route.

Any investment, irrespective of the level of investment, in an unlisted Indian company qualifies as an FDI. However, to qualify as FDI in listed companies, the minimum FDI must be at least 10%. Investments below 10% qualify as FPI, as provided below.

Further, FDI must comply with certain other conditions and restrictions applicable to the particular sector in which the FDI is made. In addition, FDI must comply with pricing guidelines, which means FDI cannot be at a price below the value of shares as determined by a valuer.

FPI

FPI investment means investment in equity shares of a listed company in India, provided the stake held is less than 10%. As mentioned above, any stake of 10% or more in a listed company qualifies as FDI. To make FPI, the investor would need to obtain a certificate from the Securities and Exchange Board of India (SEBI). This certificate is granted by a designated depository participant on behalf of SEBI, once the investor meets prescribed eligibility criteria as provided by the SEBI regulations. There are various categories of FPIs, such as: Category I FPI (including government and government-related investors, such as central banks, sovereign wealth funds, pension funds, university funds, regulated entities such as insurance and re-insurance entities, banks, asset management companies); and Category II FPI (including all categories other than Category I FPI such as endowments and foundations, charitable organisations, corporate bodies, family offices, individuals, unregulated funds in the form of limited partnership and trusts). FPI can invest in securities of listed or to be listed entities.

FVCI

FVCI means investment in *"venture capital undertaking"* (meaning a domestic unlisted company, which is not engaged in certain prescribed activities such as financial services, gold financing, etc) or investment in other domestic funds registered as alternative investment funds (as described below). It can also make investment:

- not exceeding 33.33% of its investible funds in IPOs of *"venture capital undertaking"*;
- in debt instruments of a company in which FVCI has already made equity investment; and
- in the preferential allotment of equity shares of a listed company subject to a lock-in period of one year.

To make FVCI, the investor would need to obtain a certificate from the Securities and Exchange Board of India (SEBI). This certificate is granted by a designated depository participant on behalf of SEBI, once the investor meets prescribed eligibility criteria as provided by the SEBI regulations.

Domestic Funds

Venture capital funds making domestic investments are set up as alternative investment funds (AIFs) in terms of the SEBI (Alternative Investment Funds) Regulations, 2012. AIF is a privately pooled investment vehicle which raises funds from Indian and foreign investors. There are three categories of AIF:

- Category I AIF (which invest in start-ups or early-stage ventures);
- Category II AIF (which invest in unlisted securities of mid-stage or late-stage companies, either through debt or equity); and
- Category III AIF (which employ complex trading strategies and leverage for their investments – eg, a hedge fund).

Besides getting a certificate as AIF, the AIF must comply with conditions and restrictions prescribed by SEBI for making investments in investee companies.

Structure of Venture Capital Funds

The venture capital funds have fund managers who take decisions on the investment and manage the portfolio of the fund. They are governed by the investment management agreements and are responsible for managing the investment, implementing strategies and reporting to the investors; and they must comply with the applicable regulations. The funds have an investment committee which takes decisions on investments, exits and other aspects of investment and governance, and approves the investments.

Standard Documentation

Generally, the documents executed are as follows:

- private placement memorandum – similar to an offer document and used for raising funds;
- investment management agreement – executed by the fund and the manager, governing the management of the fund; and
- contribution agreement – entered into between the investors and the fund, covering aspects such as the contribution made by the investor and other terms of investment.

2.2 Fund Economics

The economic interest for fund managers is rewarded in the form a management fee and a carry. Thus, it is in the form of *"fixed fee"* and *"share in the returns/profits"* of the fund. The carry (carried interest) is given on the units which are held by the managers. This is given as a performance-based compensation, if the return on the fund exceeds a certain agreed threshold.

Investor Protection and Governance

The fund, its key personnel, designated partners and director must abide by a code of conduct. Fund policies and procedures are reviewed from time to time. The policies must be framed to ensure that all decisions are in conformity to applicable regulations, placement memorandum, agreements with investors and other applicable laws.

The manager is responsible for decisions made in relation to the fund. The accounts and books are subject to annual audits. There are special provisions to avoid any conflict of interest and to ensure transparency of the information shared with the investor.

2.3 Fund Regulation

The applicable regulation for a venture capital fund depends on the nature of the vehicle used for setting up the fund:

- trust – the Indian Trusts Act, 1882;
- company – the Companies Act, 2013;

- limited liability partnership – Limited Liability Partnership Act, 2008.

As mentioned in **2.1 Fund Structure**, investment by the fund is governed by the FDI policy read with the Foreign Exchange Management (Non-Debt Instruments) Rules, 2019, FPI Regulations, FVCI Regulations and AIF Regulations depending upon the nature of the investment.

2.4 Particularities

There are several kinds of funds in India, such as the following:

- impact funds;
- sovereign funds;
- endowment and pension funds;
- family offices;
- infrastructure investment trusts (InvITs);
- real estate investment trusts (ReITs);
- SME funds (which invest in small and medium-sized enterprises);
- social impact funds (which invest primarily in social ventures or in social enterprises that satisfy the social performance norms laid down by the fund);
- angel funds (funds that raise funds from angel investors and invest);
- special situation funds (which invest in special situation assets in the insolvency of companies);
- debt funds; and
- fund of funds.

3. Investments in Venture Capital Portfolio Companies

3.1 Due Diligence

Before investing, VC funds conduct a detailed due diligence covering aspects such as:

- legal and regulatory;
- financial;
- business;
- commercial;
- tax; and
- environmental, social and governance.

Generally, the due diligence is detailed, and advisers/consultants are appointed to undertake the diligence exercise. A detailed questionnaire/checklist is sent to the target entity and the responses provided are examined and analysed. Due diligence findings are generally provided in the form of an executive summary (ie, a short form report and not a lengthy and detailed report) highlighting red flags/critical issues identified in the diligence. Typically, the diligence findings also provide for ways to mitigate the concerns/risks identified in the diligence. The diligence findings are resolved by seeking relevant representations, warranties and related indemnities from the investee company and its founders. Further, certain critical items are also provided as conditions precedent to making investment in the company, such as seeking regulatory approval and/or lenders' consent, if applicable. Some procedural aspects are provided as conditions subsequent (ie, to be completed within a certain agreed timeline after the closing of the investment transaction).

3.2 Process

The timeline of a new financing/funding round depends on several factors, such as the following:

- size of the transaction and the investee company;
- complexities and parties involved in the transaction;
- level of findings in the due diligence and their resolution;

- requirement of regulatory approval;
- presence of existing investors in the company;
- the transaction structure, including tax aspects; and
- the way negotiations are conducted.

Having said that, venture capital transactions are mostly fast-paced, and all parties expect the work to close quickly, and funding is completed. Typically, it could be around three to four months to complete a transaction.

The investment is made by executing certain standard agreements which govern the relationship of parties/investors. Typically, the agreements are:

- share subscription agreement (for primary investment);
- share sale and purchase agreement (for secondary investment); and
- shareholders' agreement (governing rights, obligations and governance matters among the parties) (together referred to as *"transaction documents"*).

Generally, investors get the following rights:

- board seat/observer seat;
- quorum right;
- pre-emptive right;
- anti-dilution right;
- tag-along and drag-along rights;
- right of first offer (ROFO)/right of first refusal (ROFR) with respect to share transfers;
- affirmative voting rights;
- lock-in and transfer restrictions on the founders of the investee company;
- information and inspection rights;
- non-compete obligations on the founders;
- no more favourable terms to be offered to other investors;
- exit/liquidation rights; and
- termination on breach of an agreement.

When there are large numbers of investors in an investment, while some rights are given to all investors – such as information and inspection rights, ROFO/ROFR, pre-emptive rights, anti-dilution rights – there are a few rights that can exercised by investors collectively. For example, drag-along rights could be agreed to be exercised when at least two-thirds agree to drag. The transaction documents are well negotiated and at times could take days and several rounds of discussions/negotiation between the parties.

Generally, each party to a transaction has its own counsel and adviser. Sometimes, when there is more than one investor, they engage the same counsel and adviser as the interests sought to be protected are the same.

3.3 Investment Structure

Besides equity shares, most VC funding is through compulsorily convertible preference shares (CCPS). In some transactions, compulsorily convertible debentures are seen but the most accepted instrument for investment is CCPS. CCPS are preference shares until conversion and, since the feature is of compulsory conversion, CCPS are never redeemed but compulsorily converted into equity shares within the maximum statutory conversion period of 20 years. Preference shares have priority over common stock in the payment of dividend and in the liquidation of companies. Although they have preference in the payment of dividend, in most VC deals the coupon rate is very minimal. Therefore, from this point of view, CCPS are not different from common stock. Rather, CCPS offer

the other advantage of preference in company liquidations.

Some of the common features or rights attached to CCPS are as follows:

- preference in payment of dividend;
- conversion right upon the expiry of a period or upon the happening of an event – eg, anti-dilution or corporate reorganisation;
- liquidation preference – both in winding-up and secondary sale event like IPO, trade sale;
- anti-dilution protection; and
- voting right on *"as if converted"* basis.

3.4 Documentation

As far as documentation for a VC deal is concerned, generally the following documents are common:

- a term sheet, which is generally non-binding except for a few clauses like cost and expenses, exclusivity and confidentiality;
- a share subscription agreement for primary issuance of shares;
- a share sale and purchase agreement for a secondary transaction;
- a shareholders' agreement, which governs the rights and obligations of the parties and the provisions regarding management and governance of the investee company; and
- sometimes, specific letter agreements are also executed among several parties to record some understanding between such parties.

3.5 Investor Safeguards

Downside Scenario – Liquidation Preference

To protect investors in *"downside scenario"* such as the winding-up of a company, liquidation preference provisions are provided. Indian insolvency law provides for a waterfall mechanism (ie, the order in which the liquidation proceeds will be distributed). As mentioned above, CCPS, being preference shares, are paid in priority to the common stock. Indian insolvency law provides that any contractually agreed priority for the same classes of shares will not be enforceable in law. For example, holders of equity shares cannot have priority over each other; however, preference shares can have priority over equity shares.

Besides winding-up, where the liquidation preference is statutorily governed, liquidation preference can be contractually agreed in events such as exits by investors upon a strategic sale or change of control of a company, while enforcing drag-along rights and any other form when the existing investors/shareholders sell their shares through a secondary sale. In such sale, the investor is provided with a liquidation preference, vis-à-vis the founders of the company. As amongst investors, the distribution is made in proportion to their shareholding unless it is agreed that earlier series/round investors will be paid in priority over the investors of the later series/round.

Liquidation preference is mostly participating in nature, which means that once the investors have been paid their principal amount (ie, original investment), they will then participate pro rata in the amount remaining for distribution.

Anti-Dilution and Pre-Emption/Subscription Rights

These are common provisions in VC transactions in India. Both anti-dilution and pre-emption/subscription rights are provided in the shareholders' agreement. Anti-dilution rights are provided for a certain number of years, such that if a down-round happens during that period, the investor is protected through anti-dilution protection. Anti-

dilution rights could be full-ratchet anti-dilution or broad-based weighted average anti-dilution. Although investors negotiate for a full-ratchet anti-dilution right as it is best from the investor's perspective, generally the acceptable standard in India is to have a broad-based weighted average anti-dilution.

It is common to have pre-emption/subscription rights to the extent of the shareholding of an investor. If an investor does not exercise this right, the same can be offered to the other investors.

3.6 Corporate Governance

Typically, investors exercise their influence over management/affairs by having certain rights in the investee company. Some of these rights are as follows.

- Board seat or observe seat including right to replace the nominee director or the observer. The director or observer has a right to attend a board meeting (but observer is not counted towards quorum and does not have a right to vote) and are entitled to examine the books, accounts and records of the company and shall have free access, at all reasonable times and with prior written notice, to properties and facilities of the company. The company is obligated to provide such information.
- Right to have notice and the agenda of meetings.
- Quorum right both in the board and shareholders' meeting – If the investor nominee is not present, the meeting stands adjourned. If the quorum is still not met in the adjourned meeting, then the meeting proceeds without the investor nominee, but affirmative vote items are neither discussed nor voted upon at such meeting.
- Affirmative voting matter (AVM) right – AVM rights require the company to obtain prior written consent from the investor prior to taking decisions on critical matters – eg, alteration of charter documents, acquisition of other businesses and amendment of the annual business plan.
- Information and inspection rights.

3.7 Contractual Protection

Typically, investors seek representations and warranties, which can be broadly categorised as follows:

- fundamental warranties (covering fundamental issues like title to the shares/property, authority and capacity to enter into the agreements);
- business warranties (covering all aspects relating to the operations of the business of the company);
- tax warranties (covering aspects relating to taxation); and, sometimes,
- special warranties (sought for certain specifically identified indemnity items).

These representations and warranties are taken as of the signing date of the transaction and are repeated as of the closing date of the transaction. Any change in the representations and warranties from the signing date to the closing date is disclosed through a disclosure letter, such that the investor has a right to walk away from the transaction if the representations and warranties differ from those represented on the signing date.

The representations and warranties are well negotiated between the parties, and it is one of the critical areas of negotiation in a VC transaction. If there is any breach of representations and warranties prior to the closing of the transac-

tion, then the investor has a right to terminate the transaction without any recourse, except for legal and other expenses and cost incurred by the investor. Generally, investors ask for indemnity for the breach of representations and warranties prior to closing but as standard practice such indemnities are not given. If there is a breach of representations and warranties after the closing of the transaction, then investors have a right to seek indemnity and other remedies available in law. Generally, the indemnities are qualified and limited to a certain agreed amount and time within which the indemnity can be sought. Typically, the threshold amount and time limit agreed depend on the nature of representations and warranties.

4. Government Inducements

4.1 Subsidy Programmes

Generally, there are no government/quasi-government programmes to incentivise equity financing in growth companies. However, if the company is a start-up as per the definition prescribed by the government, certain provisions of law are exempted for such companies. Further, from time to time the government announces certain benefits and schemes for a particular industry/sector, which can be availed of by complying with the conditions of such schemes (eg, the Production-Linked Incentive (PLI) schemes).

4.2 Tax Treatment

As mentioned in **1.2 Key Trends**, angel tax has been abolished and long-term capital gains on unlisted shares has been reduced from 20% to 12.5%. This will lessen the tax burden on the selling shareholders and result in investors earning a better rate of return on exit. Foreign investment by venture capital is also subject to the double tax avoidance agreement (tax treaty between India and other countries), eg, India and Singapore.

4.3 Government Endorsement

To attract investment, the government announces schemes and incentives from time to time. The government has been trying to improve the ease of doing business and as part of that has provided businesses with single window clearance under the National Single Window System (NSWS).

As mentioned in **4.1 Subsidy Programmes**, the government has announced the PLI scheme and gives incentives to start-ups.

5. Employment Incentives

5.1 General

The founders/key employees' long-term commitment to the venture is sought by contractually agreeing to some of the following standard provisions:

- non-compete and non-solicitation restrictions;
- restriction on transferability of shares through lock-in of shares;
- obligation to devote full and whole time to the business of the investee company; and
- providing for stringent clauses for breach of these obligations, such as a call option on the founder's shares at a discounted price.

5.2 Securities

Instruments/securities typically used for the purpose of incentivising founders/employees are as follows:

- employee stock options (ESOPs);
- management stock options;

- sweat equity shares;
- stock appreciation rights; and
- restricted stock units.

5.3 Taxation of Instruments

Taxation of ESOPs

As per the Indian income tax laws, the taxation of ESOPs is triggered at two stages.

At the time of exercise of options as a perquisite

The tax will be levied on the notional profit at the time of exercising the ESOPs calculated as the difference between the share's prevalent fair market value (FMV) on the exercise date and the exercise price paid on ESOPs.

At the time of sale of shares as capital gains

Gains derived at the time of sale of shares which are allotted pursuant to ESOPs will be subject to capital gains tax in India. The taxable value is calculated on the excess of sale price of shares over the fair market value of shares on the exercise date. The tax is applicable on the period of holding of shares before sale. If the shares are held for a period exceeding 24 months, then the tax is calculated at the rate of 12.5% and if held for a period less than 24 months, tax will be calculated as per the applicable tax rate.

5.4 Implementation

Generally, at the time of investment in an investee company, a certain pool for ESOPs is kept aside for employees; generally it ranges from 2.5% to 5%. Sometimes the investment round allocates capital to implement and fund employee incentive programmes by providing what is recorded in the shareholders' agreement; and this is effected as a condition precedent to the closing of the transaction.

6. Exits

6.1 Investor Exit Rights

For exits vis-à-vis the founders, the investors get a priority for exit (ie, they have preference over the promoters/founders at the time of exit). Exits typically happen pursuant to:

- a sale in the IPO;
- trade/strategic sale;
- tag-along (when there is a change in control);
- drag-along;
- buyback of shares by the investee company; or
- a combination of one or more of such methods of exit.

Exits vis-à-vis other investors happen on a pro-rata basis (ie, the investors get a proportionate share of the proceeds on exit). Typically, exits happen after five to six years of investment. Should there be a breach or any event of default, the investors have a right of exit even before the agreed term of exit.

6.2 IPO Exits

IPO exits are still the most preferred mode of exit. Over the years, investors have exited through IPO by being the selling shareholders in the IPO. As mentioned at **1.1 VC Market**, as per the Bain & Co report, some notable exits in 2024 include exits of investors in Policy Bazaar, Paytm, Mamaearth, Indigo Paints and Prataap Snacks.

IPO is a long process and is driven by SEBI regulations. All rights of the investors fall away on the IPO. India has robust and well-established capital markets, with two major stock exchanges: Bombay Stock Exchange (BSE) and National Stock Exchange (NSE). The IPO process is primarily divided into pre-issue, launch prepara-

tion and post issue activities. At pre-issue, due diligence, drafting and the filing of a draft red herring prospectus with SEBI happens through a merchant banker. SEBI provides its comments. Thereafter, during the launch preparations, the following take place:

- pre-marketing investor meetings;
- filing of updated draft red herring prospectus with SEBI;
- filing of red herring prospectus with the Registrar of Companies;
- road shows; and
- announcement of a price band of the IPO price.

At post issue:

- the issue opens and closes;
- the final IPO price is fixed;
- allotment is made; and then
- securities are listed on the BSE and NSE.

6.3 Pre-IPO Liquidity

Secondary market trading transactions do happen prior to an IPO but they are not prevalent. This is because most exits happen through the IPOs. In fact, instead of secondary sale, a pre-IPO allotment is seen to increase the shareholding of some existing investors or to bring in new investors. Having said that, there could be situations where certain investors or employees would like to exit prior to the IPO. In that case, the founders and company can facilitate this secondary sale, but there is no obligation to do this. Typically, such pre-IPO transfers are not provided for in the shareholders' agreement but can be facilitated if there is mutual agreement between the parties.

7. Regulation

7.1 Securities Offerings

Broadly, the offering of a company's equity securities in a venture capital transaction entails the following.

- Approval of the board of directors of the investee company. Generally, securities are issued by way of private placement, which means issuance of shares to an identified person to the exclusion of the other shareholders of the company (Private Placement). Shares can also be issued on a rights basis on a pro-rata basis to all existing shareholders of a company (Rights Issue). In a venture capital transaction, securities are issued to an identified investor(s) (and not to all the shareholders), so they are issued on a Private Placement basis.
- Once the board approves the Private Placement, approval by way of special resolution (ie, three quarters) of shareholders is required. It may be noted that no shareholders' approval is required for a Rights Issue.
- Issuance of shares on a Private Placement basis requires valuation from a registered valuer. This condition is applicable irrespective of whether it is a domestic investment or a foreign investment. If equity shares are issued, then valuation must be carried out at the time of their issuance. If convertible securities are issued, then the price of the resultant equity shares that will be issued upon conversion of the convertible securities is determined as either:
  (a) upfront at the time when the offer of convertible securities is made, based on the valuation report of a registered valuer given at the stage of such offer; or
  (b) at a later time, which shall not be earlier than 30 days from the date when the

holder of convertible securities becomes entitled to apply for shares, based on the valuation report of the registered valuer given not earlier than 60 days from the date when the holder of convertible securities becomes entitled to apply for shares.

The decision of the option to be adopted must be taken at the time of issuance of the offer of securities.

- The offer of securities is made through a private placement offer letter in a prescribed format which is sent to the proposed allottees of shares.
- The proposed allottees apply for the shares by remitting the funds into the company's bank account.
- The shares are then allotted by the company, generally, in a dematerialised form.
- The shareholder is recorded in the company's record of shareholders.
- A prescribed online form with details of the allotment made is filed with the Registrar of Companies.
- In addition, the investment could also require regulatory approval – eg, if the acquisition is 26% or more in a financial services company, then prior approval of the Reserve Bank of India will be required.

7.2 Restrictions

There are some regulatory and other restrictions that must be borne in mind when a foreign VC investor is considering investments in India. Some of these restrictions are given below.

- As mentioned in **2.1 Fund Structure**, irrespective of the sector in which investment is made, if FDI is made by (i) an entity of a country sharing land border with India; or (ii) where the beneficial owner of an investment into India is situated in or is a citizen of any country sharing land border with India, FDI can only be made under the government approval route. Therefore, a foreign VC investor must bear this condition in mind. In this regard, it may be noted the restriction is on investments made through a fund which is sponsored and/or beneficially owned by investors who are residents of countries sharing land border. The residency status of the manager or the limited partner will not be the relevant criterion.
- Investment made should be following the investment criteria specified in the SEBI regulations.
- Investment made in the form of FDI must comply with the pricing guidelines, which means the investment made cannot be lower than the price determined by a valuer. This is applicable when the foreign investor is making investment through primary issuance or secondary acquisition.
- Compliance with sectoral caps for specific sectors (which means investment limits up to which the investment can be made under the Automatic route) and other restrictions and conditions provided in the FDI Policy and the NDI rules.
- For transfer of shares to a person a resident in India, the provisions of tax withholding apply when payment is made to a non-resident investor. Therefore, this would need to be checked at the time of exit by a foreign investor.
- Liquidation preference in case of winding up of the investee company will be subject to the insolvency law waterfall mechanism provided.
- The instruments that can be used for investment could be equity shares or compulsorily convertible securities (such as CCPS). All other kinds of instruments are treated

as external commercial borrowing and will require compliance with the ECB guidelines.

- As foreign investors, foreign VC funds will not be entitled to any assured return (ie, on exit they cannot repatriate more than the value of shares as determined by a valuer). They can exit by exercising a put option after a minimum lock-in period of one year from the date of investment.
- Foreign VC must ensure that the terms of the shareholders' agreement are incorporated in the investee company's articles of association (ie, the by-laws of the investee company), otherwise the terms will not be enforceable.

Trends and Developments

Contributed by:
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JSA Advocates and Solicitors is a prominent venture capital advisory law firm in India, renowned for its innovative and client-centric approach. It partners with major Indian businesses and international corporations across diverse sectors. Specialising in seamless venture capital transactions, JSA collaborates closely with in-house legal teams, investment firms and financial advisers. The firm's nationwide practice structure consists of expert lawyers and offices in key locations, offering cost-effective services. JSA manages various venture capital deals, including funding rounds, acquisitions, exits, and restructurings. Its sector-specific expertise ensures a deep understanding of industry challenges, delivering tailored solutions. With over 30 years of experience, JSA expertly handles regulatory, economic and transactional complexities. Offering end-to-end services, JSA supports clients with structuring, due diligence and drafting agreements, and represents them before relevant authorities. Its integrated approach guarantees clients receive comprehensive advice throughout the investment process.

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Introduction

After an unprecedented funding high in 2021, when Indian start-ups raised around USD38 billion, the Indian VC market saw a significant pullback in 2023. Heightened global inflation, rising interest rates and geopolitical tensions led to risk aversion worldwide. India was no exception as total venture funding in 2023 plummeted to roughly USD9.5 billion.

In 2024, market reports indicate that funding bounced back to about USD13–14 billion. This was roughly a 40% increase from the 2023 trough, though still well below the 2021 peak frenzy. Notably, the first half of 2024 saw steady deal flow even amid India's general elections. Investor surveys at the start of 2025 show optimism is returning. January 2025 saw a sequential increase in PE/VC investment activity month-on-month.

Importantly, the character of funding activity has shifted. The *"growth-at-all-costs"* ethos of 2021 has been supplanted by a more measured approach emphasising value and profitability. In 2024, investors gravitated towards start-ups demonstrating solid unit economics or a clear path to break-even, rather than pure top-line growth. Many founders, responding to the lean funding climate of 2022–23, had already rationalised their businesses by cutting burn rates, focusing on core products and prioritising sustainable growth. As a result, by 2025, a number of Indian start-ups are leaner and closer to profitability, which in turn is attracting investors back with renewed confidence.

Venture capital firms are conducting more rigorous due diligence and taking their time before closing deals. While total deal volumes in 2024 remained below the peak, the average quality of deals improved with a bias towards smaller but substantive rounds. Early-stage investments proved relatively resilient even during the downturn, seed and Series A rounds in 2023 were only marginally lower than the prior year, and 2024 saw those early-stage bets continue. In contrast, late-stage funding, Series D and beyond, that had been hit hardest in 2023 remained somewhat subdued in 2024, except for select big-ticket financings in mature start-ups with strong metrics.

Valuations and Investor Caution

Valuation trends in 2024 reflected a marketplace still finding equilibrium. After the steep valuation markdowns seen in 2023, when several high-profile unicorns saw their paper valuations cut by

30–50% or more by investors, 2024 valuations stabilised at more rational levels. Late-stage companies that had raised funds at inflated 2021 valuations often had to reset expectations. In 2024, investors were generally no longer willing to pay a premium solely for rapid growth but rather focused on profitability or market leadership. The result was that many funding rounds in 2024 were flat or only modest uplifts from prior rounds, unless the company had substantially improved its metrics.

In 2025, with interest rate pressures expected to ease, there is a sense that investor risk appetite will gradually improve. The consensus among VCs is that the Indian market's long-term fundamentals, a vast digital consumer base, strong tech talent, and untapped problems waiting for tech solutions, remain intact. Thus, while sentiment is not back to exuberance, it is decidedly more optimistic in 2025 than in the previous two years.

Sectoral Trends

In 2023, certain sectors demonstrated resilience and even outperformed others, and these trends carried into 2024. The past year saw a flight to quality, with investors concentrating capital in sectors viewed as having strong unit economics or long-term growth potential, while pulling back from overheated areas. In 2025, the sectoral composition of venture activity in India has shifted, with some newer themes emerging alongside the established favourites.

Sectoral trends: from fintech to frontier tech

The flight to quality has defined the sectoral distribution of capital, with relatively durable or high-potential verticals attracting the most attention.

- Fintech – Fintech continues to be a cornerstone of India's start-up ecosystem, attracting a significant share of VC dollars. In 2024, funding in fintech companies remained robust with approximately USD2 billion going into the sector. Notably, a few large deals skewed this figure. For instance, the DMI Finance raised USD334 million. Even excluding such deals, investor interest in fintech stayed high. This is despite regulatory tightening by the Reserve Bank of India (RBI) in certain areas, such as stricter Digital Lending Guidelines issued in 2022 and limits on prepaid instrument loading which posed challenges to some fintech business models. By 2024, many fintech start-ups adapted to the new rules, and regulators also showed a collaborative stance. For example, the RBI permitted fintech lenders to offer first-loss default guarantees in partnership with banks, under certain conditions. This eased a key concern for digital loan platforms. Going into 2025, emerging trends like AI-driven financial advisory and embedded finance are expected to drive the next leg of fintech growth. Industry projections estimate that India's fintech market could reach around USD150 billion by 2025, making this sector a VC magnet.
- Consumer tech and e-commerce – The consumer technology sector emerged as a standout performer, with funding escalating 2.3 times to USD5.4 billion. This growth was primarily driven by rapid consumer adoption and clear profitability paths in segments like quick commerce within B2C commerce. Notable investments included Zepto, which secured USD1.4 billion, reflecting the sector's robust appeal to investors.
- Software and SaaS – The software and Software-as-a-Service (SaaS) sector, including generative artificial intelligence (AI) start-ups, also saw substantial growth, with funding

rising by 1.2 times to USD1.7 billion. This increase was fuelled by growing customer spending on development and testing tools, as well as the maturation of international go-to-market strategies. Generative AI funding, in particular, grew by 1.5 times, reflecting the global AI boom's impact on India.

- Climate tech, EVs and deep tech – Government incentives spurred around USD600 million in funding for EV start-ups in 2024. Climate and clean-energy solutions also gained traction as specialised funds entered the market. Space tech received a major boost from policy reforms permitting higher FDI in satellite and launch ventures, with multiple space-tech start-ups securing funding.
- Cooling sectors – Edtech's decline after the COVID-19 pandemic era has been stark, while healthtech had mixed results. Crypto/Web3 start-ups struggled under India's tight stance on cryptocurrencies and heavy transaction taxes, diverting some entrepreneurs to friendlier jurisdictions. Still, the broader reallocation of capital suggests a healthy correction away from overheated pockets.

Shifts in Investor Base and Strategy

During the liquidity surge of 2021–22, foreign and crossover investors were prolific in India. In 2023–24, some pulled back, particularly from Japan and China, while Middle Eastern sovereign funds (eg, ADIA, PIF) became more active. Domestic investors, including family offices and the government's Fund of Funds for Start-ups (FFS), stepped up significantly, creating a more balanced capital mix. In 2025, Indian VC is expected to be less vulnerable to a single source of funding, enhancing ecosystem stability.

Investors have also adopted sharper theses and become more hands-on. Rather than spraying capital across numerous sectors, many VC firms now concentrate on areas where they possess deep expertise. Protective clauses in term sheets, liquidation preferences, anti-dilution and founder lock-ins are common, reflecting a heightened focus on governance. Collaboration among VCs increased as well, with more club deals involving multiple investors who pool expertise and share risk.

India-centric funds continue raising fresh capital, joined by corporate venture arms from large conglomerates seeking strategic stakes in fintech, AI and other promising sectors. There are also first-time foreign entrants who see India as part of *"China+1"* strategy, diversifying their Asia portfolio.

Exits and Liquidity

After a near-freeze in 2022, exit activity revived in 2023–24, though it did not match the exuberance of 2021. India's IPO window reopened cautiously for venture-backed companies with strong fundamentals. Landmark listings included Swiggy, Ola and FirstCry. These successes indicated that the domestic markets could absorb tech IPOs when the financials were robust.

M&A and secondary sales, however, played an even bigger role in driving exits. In 2023–24, a substantial share of VC exit value came from secondary transactions, where late-stage funds or sovereign investors bought stakes from early backers without the start-ups going public. Strategic acquisitions by corporate giants, Reliance Industries, the Tata Group and large unicorns, have also consolidated technology and talent under larger platforms. While exit timelines remain protracted compared to earlier hopes, the environment in 2025 is expected to be markedly healthier than it was in 2022.

Regulatory and Policy Developments Impacting VC

India's government has continued efforts to simplify business operations and promote start-ups, with several notable reforms in 2024–25.

- Angel Tax Abolished – After years of controversy, the *"angel tax"* was finally removed. Previously, capital raised by a start-up at a premium above fair market value could be taxed as income. Eliminating this provision smooths fundraising for early-stage companies, removing a key barrier for both domestic and foreign investors.
- Extended Tax Holiday – Eligible start-ups now enjoy a three-year tax holiday within their first decade of incorporation, extended to those formed by 31 March 2025. While not all young companies reach profitability so quickly, it remains a valuable incentive for those that do. VCs are more likely to invest in start-ups that have a clearer path to profitability.
- AIF Regulations – SEBI introduced guidelines to help older venture capital funds transition to the alternative investment fund (AIF) regime, aligning them with modern governance requirements. Proposed changes to angel fund norms could permit larger individual investments (up to INR250 million) and shorter lock-ins, thus stimulating more robust early-stage funding.
- FDI and Sectoral Policies – Further liberalisation of foreign direct investment, especially in space tech (up to 100% FDI) and semiconductor manufacturing (aided by production-linked incentives), attracted multinational interest. These policy shifts create ancillary opportunities for start-ups in hardware, electronics supply chains and deep tech.
- GIFT City Incentives – Gujarat International Finance Tec-City (GIFT City) offers tax and regulatory benefits for fund managers setting up local entities. This move aims to bring more India-focused capital onshore, reducing dependence on offshore jurisdictions like Singapore or Mauritius. Fund managers establishing entities in GIFT City can avail themselves of several benefits such as tax holidays, GST exemptions, capital gains tax exemptions, etc.

Governance and Operational Trends in Start-Ups

Tighter funding conditions and several governance scandals in 2022–23 accelerated the push towards better discipline and transparency. Numerous start-ups cut operating costs, focusing on core products and profitability to extend their runways. Investors now typically insist on thorough audits, stronger internal controls and better board oversight before cutting large cheques. Independent directors and structured reporting are increasingly standard, even at Series A or B stages, which is a significant departure from the lax governance norms of the past.

Transparency with stakeholders has improved. Founders often share detailed monthly or quarterly updates with their cap tables, recognising that consistent communication fosters investor trust and longer-term backing. ESOP schemes remain popular, enabling start-ups to align employee incentives with growth and conserve cash. Compliance has also gained prominence, from adhering to tighter RBI regulations in fintech to preparing for India's new data protection law. Many see robust governance as a competitive advantage rather than a bureaucratic burden, especially with larger fundraises and potential IPOs on the horizon.

Outlook for 2025 and Beyond

India's VC ecosystem is rebounding from the 2023 trough, and the mood in 2025 is cautiously optimistic. Inflationary pressures are moderating worldwide, raising hopes for a more benign interest-rate environment. The pipeline of maturing start-ups in India is robust, and, if a few marquee IPOs or acquisitions demonstrate strong performance, it could trigger a broader resurgence in late-stage funding. At the same time, the lessons from the recent downturn remain fresh – valuations must reflect tangible achievements, and governance missteps are no longer tolerated.

Founders with sustainable, scalable models can anticipate solid investor interest, whether from domestic sources, VC funds, family offices, government initiatives or from global players eyeing India's enduring growth story. This environment is especially supportive of start-ups in fintech, SaaS, climate tech and AI-driven solutions. Post-2025, India may well cement its position as the world's third-largest start-up ecosystem, behind the US and China.

For foreign investors and businesses, India's evolving policy framework and deepening local capital pool create both opportunity and complexity. Navigating regulations, forging local partnerships and conducting thorough due diligence are critical. Still, the market's long-term fundamentals, size, talent, digital adoption and policy momentum remain highly compelling. The coming years could witness a self-sustaining cycle of innovation, investment and liquidity events.

INDONESIA

Law and Practice

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KARNA is an Indonesian law firm focusing on corporate/commercial law as well as litigation and ADR. It provides sophisticated legal counsel to entities of any size and in any stage of development – from burgeoning start-ups to large blue-chip companies – in various practice branches, including M&A transactions, company restructuring, digital economy, private equity/venture capital transactions, content and entertainment, financial services, banking, financing, capital markets, employment, and any other aspects of corporate and commercial law applied in a number of industry fields. The team currently consists of 18 lawyers comprising five partners, 11 permanent associates and two of counsels. To fulfil client global expansion needs, KARNA provides worldwide legal services via the firm's extensive international association network, Withersworldwide. Withers spans the USA, Europe and Asia in order to support clients effectively, with a focus on private individuals and their enterprises. Withers also advises global brands, technology and life sciences businesses, charities and governments.

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1. Trends

1.1 VC Market

The decline in venture capital tech transactions has continued in the past year, where Indonesia has not seen any deal of pre-pandemic landmark size. The closest was the USD1.1 billion public raised by GoTo in 2022, which was the third-largest IPO in Asia and the fifth largest in the world at that time. Despite this, there have been several transactions in 2024, including the acquisition of GoTo's e-commerce platform, Tokopedia, by the giant social commerce platform from China, TikTok, with a transaction value of USD1.84 billion; and IPO conducted by Mr DIY, a homecare products retail company, with a total raised amount of IDR4.15 trillion (around USD276 million).

1.2 Key Trends

According to the 2024 e-Economy South-East Asia Report jointly issued by Google, Temasek and Bain & Company, private funding for digital businesses in the South-East Asia region remains subdued, mainly caused by higher interest rates and shifts in the geopolitical landscape. Deal-street Asia also reported that Indonesia saw the steepest decline in both deal volume and value in 2024. During this *"tech winter"*, Indonesian start-ups have been struggling to secure funding as investors become more cautious amid global economic uncertainties. Those with enough runway also avoid equity fundraising due to lower valuations, and have considered alternative financing options, including venture debt or conventional bank loans. This has prompted start-ups to prioritise a path to profitability. Despite this, there are still growing opportunities and activities in sectors such as healthcare, green energy and natural resources.

Given the foregoing, more venture capitalists are asking for greater protections in the event of down round, including more anti-dilution rights, a higher liquidation preference multiplier, additional governance requirements and more information rights. Transaction structures remain largely similar for purely domestic players where it is mostly Indonesian limited liability company (*Perseroan Terbatas*, or PT) to PT investment in Indonesia. Where transactions involve foreign venture capitalists, an offshore holding vehicle of the Indonesia company would be set up to

receive funding or foreign venture capitalists would directly invest in the PT.

Further, Indonesia continued to experience widespread lay-offs across many tech start-ups in 2024, including the likes of Tokopedia (e-commerce, efficiency following the acquisition by TikTok), Mekari (company SaaS platform), Xendit (fintech), as companies pursue profitability. Other companies, such as eFishery (agritech) and Investree (peer-to-peer lending), have been under investigation for fraud involving inflated assets and revenues or embezzlement. These events have also affected investors' risk appetite even though they do not necessarily reflect the management practices of all tech companies.

For the record, eFishery had just bagged USD200 million funding in 2023 enabling them to reach unicorn status, while Investree had raised a total funding of at least USD230 million. These cases have provided important lessons for the Indonesian VC industry. It serves as a clear reminder that even well-funded start-ups with unicorn status are not immune to internal fraud or mismanagement. One key takeaway is the need for strong internal controls, independent audit committees and a professionally structured board, especially as start-ups grow in scale. Involving third-party audits and oversight mechanisms should also begin as early as the growth stage, while balancing the need for founders to implement their vision. Additionally, investors must avoid placing excessive trust in a founder's charisma or vision alone. A more rigorous founder vetting process, covering character references, conflict of interest reviews and background checks, is essential. Likewise, founders should also work to build greater trust by maintaining transparent communication with their shareholders, embracing founder accountability — including avoiding blurred lines between personal and company assets or decision-making, and strengthening governance structures.

1.3 Key Industries

Lately, investors tend to not have preferences for specific industries, but rather focus on the sustainability aspect of the potential investee. Companies that are already profitable or have a clear roadmap towards profitability are more attractive for investors compared with those that are not yet profitable. However, there are indications that fintech continues to dominate the space of recent financing rounds in Indonesia, while more are seen venturing into healthcare, green energy and natural resources. At the same time, more venture capitalists are looking to exit later-stage tech companies or get partial liquidity.

2. Venture Capital Funds

2.1 Fund Structure

The operation of venture capital funds is specifically regulated by the Indonesian Financial Services Agency (*Otoritas Jasa Keuangan*, or OJK). Pursuant to the relevant OJK regulation, in order to establish a fund, the relevant entity must apply to the OJK for a venture capital licence and fulfil the relevant requirements, such as minimum paid-up capital requirements. Although there are several options, most local venture capital funds are organised as a PT, with a very few firms operating as a Sharia business unit.

Further, the establishment of a venture capital fund for the pooling and management of investors' funds must be made through a mutual investment contract entered into by the licensed venture capital company and the appointed custodian bank. This mutual investment contract serves as an underlying for:

- the licensed venture capital company binding the investors, pooling and managing the investors' fund; and
- the appointed custodian bank performing collective custody related to the fund.

The relevant interest within the venture capital fund is divided into a number of investment units.

In managing the fund, the licensed venture capital company has the duties of, inter alia:

- taking any decisions in goodwill for and on behalf of the investment unit holders;
- managing and maintaining all book-keeping and any other important records of the fund;
- providing necessary information regarding the fund's investment risk;
- preparing the fair market value of the fund's investees and submitting to the custodian bank every month;
- preparing the calculation formula for the fair market value of the fund's investees in a consistent manner and preparing the net asset value of the fund; and
- implementing the AML/CFT and prevention of proliferation of weapons of mass destruction programmes.

The book-keeping and any other important records of the fund must be separated from the book-keeping and any other important records of the licensed venture capital company (at company level).

In supporting the fund, the appointed custodian bank has the duties of, inter alia:

- performing collective custody of the fund's assets;
- calculating the net asset value of the fund every month;
- making payment of the fund's expenses;
- managing and maintaining data regarding the investment unit holders; and
- representing the investment unit holders collectively for the placement of the fund's investments.

Comparing with typical venture capital fund structures in other jurisdictions, a licensed venture capital company acts a general partner (GP) and investment unit holders act as limited partners (LPs) in a limited partnership structure. Further, a mutual investment contract serves as a limited partnership agreement.

2.2 Fund Economics

Venture capitalists generally earn management fees from a venture capital fund and have the opportunity to negotiate the carried interest and hurdle rate. As discussed in **2.1 Fund Structure**, in Indonesia, a licensed venture capital company acts as the fund principal. As the fund principal, the licensed venture capital company is not required to participate in the economics of the venture capital fund that it establishes but may earn fees from the management of the fund. Licensed venture capital companies who manage venture funds are also subject to more strict requirements, including having at least one manager with an investment manager representative licence, standard operational procedures on venture fund management and teams dedicated to risk management, internal audit IT, and AML (to name a few). They will need to consider these costs in negotiating the fee with investors. Further, if they also participate in an investment, they will also benefit from any capital gains when the fund is liquidated.

Separately, the relevant OJK regulation obliges the licensed venture capital company to have minimum equity (assets minus liabilities) of

IDR50 billion (approximately USD3.3 million) to establish a venture capital fund. When applying for the venture capital licence, the applicant must also have a minimum paid-up capital of IDR50 billion (approximately USD3.3 million), which means that the shareholders of such applicant must have injected such amount before starting to operate.

2.3 Fund Regulation

As discussed above, venture capital funds are regulated by the OJK. The OJK has also recently enacted new regulation, POJK 25/2023, specifically governing the operation of venture capital funds. This regulation replaced prior regulations and introduced, among other things, two venture models – namely, venture capital corporation (VCC) and venture debt corporation (VDC) and more detailed requirements for venture capital funds.

The OJK may also potentially require offshore venture capitalists to set up a representative office in Indonesia in a new draft regulation for greater oversight. It remains to be seen how this new regulation will be implemented.

2.4 Particularities

An abundance of Indonesian-focused funds or Indonesian-based companies are establishing venture capital funds in foreign jurisdictions, such as Singapore, where tax regulations might be more favourable than in Indonesia. Apart from being established by Indonesian companies, these venture capitalists also heavily invest in Indonesia. One of the main reasons for choosing foreign jurisdictions is the capital gain tax regulations on the sale of shares that is applicable under Indonesian taxation regulations.

Domestically, based on publicly released data by the OJK, several state-owned banks have established venture capital companies within Indonesia's jurisdiction (as per OJK regulations) such as Mandiri Capital (Bank Mandiri), BRI Ventures (BRI) and BNI Ventures (BNI). Like other corporate-backed venture capital companies, the establishment of these venture capital companies is aimed at seeking portfolios that align with their core businesses.

The establishment of Danantara, a new sovereign wealth fund and investment management institution, established by the new government of Indonesia (inaugurated in October 2024) may also affect the investment landscape in Indonesia. The establishment and implementation of Danantara are manifested through major revision of the state-owned enterprises (SOEs) law under Law No 1 of 2025 (the *"SOEs Law"*). Pursuant to the new SOEs Law, Danantara has been granted the authority to directly enhance and optimise SOEs' investments and operations. With the establishment of Danantara, dividends derived from SOEs, which were previously deposited into the state treasury, will now be managed by Danantara to ensure optimal utilisation, including as a driving force in VC transactions as is commonly done by other sovereign wealth funds (eg, GIC, PIF or QIA).

3. Investments in Venture Capital Portfolio Companies

3.1 Due Diligence

This would depend on the risk appetite of the investors, industry of the target company and the funding stage of the target company. Earlier rounds would typically mean less diligence compared with later rounds. Highly regulated areas (eg, energy and financial services) would typically require a more comprehensive due diligence process. Very minimal diligence has been

observed in the case of venture capitalists with a greater risk appetite.

In a similar manner to other industries, the due diligence process is intended to reveal the realistic condition of the target company for the investors' consideration before they decide to proceed with the transaction or not. Several key aspects that must be reviewed during the due diligence process include:

- corporate (and constitutional) documents;
- licences;
- material contracts;
- assets;
- employments; and
- disputes.

With regard to an investment made by venture capital fund investors, the degree of scrutiny would depend on the development of the target company. By way of example, when representing venture capital fund investors from a legal point of view, the authors would not put the absence of owned land assets in the red flag findings list for a tech start-up company.

Commonly, the main focus of the due diligence process is on the operations of the target company and whether the operations can justify the numbers, key metrics and/or achievements presented by the target company to the investors; and whether there are crucial issues (eg, tax liabilities or key disputes) that may impact pricing.

3.2 Process

As companies become less likely to receive funding, owing to lower valuations and venture capitalists becoming more cautious amid macroeconomic uncertainties, the timeline for getting a new financing round may take longer than before the COVID-19 pandemic. However, this primarily depends on whether the company has sufficient runway or whether there is access to funding. The relationship between investors would depend on how the management communicate/manage the narrative (eg, is it a friendly co-investor or strategic buyout?) and whether or not the rights of existing investors are adversely affected in the new round. If the rights of existing shareholders are adversely impacted, the dynamics would be harder to manage.

Usually, each co-investor would retain a separate counsel. Most investors now also have in-house counsel managing transactions without external counsel (depending on the size/complexity of the deal). Most deals require majority approval unless there is a down round or a major liquidation event (eg, merger or trade sale).

3.3 Investment Structure

Although the OJK primarily recognises only two types of instruments (ie, primarily equity and loan), Indonesia has also seen instruments such as Simple Agreements for Future Equity (SAFEs) and mandatory convertible notes that are usually structured through investments in offshore holding companies.

If the investment is made directly through an Indonesian company, Indonesian law applies a minimum paid-up capital of IDR10 billion (approximately USD700,000) for companies intending to have foreign shareholder(s) (either foreign individual and/or foreign entities) (the *"FDI Co"*), regardless of the amount being invested by such foreigner. Once shares are issued to foreigner, the minimum paid-up capital must be fulfilled. Moreover, under Indonesian law, a subsidiary of an FDI Co would be considered as a foreign person/entity when it intends to acquire shares in another company. Therefore, in order to onboard foreign investors, companies must

make sure that their paid-up capital meets the applicable requirement.

In light of this, the structure commonly used is the issuance of a convertible loan by a target company to be subscribed by the foreign individual, foreign entities and/or FDI Co. With this structure, there are no shares issued for the receipt of fresh funding. Therefore, early-stage target companies are not required to become an FDI Co and the minimum capital requirement is not triggered. The loan can be converted into shares once the start-up company is ready to become an FDI Co.

3.4 Documentation

For shares issuance, the typical key documents are:

- term sheet, which outlines the financing structure including the exclusivity period during the due diligence process;
- shares subscription agreement, which governs the issuance of shares including the conditions that must be met before and after the disbursement of the funding, as well as warranties given by the company and the founders regarding the company; and
- shareholders' agreement, which essentially provides the investors with minority protection in the event the investors choose to maintain the founders' majority shareholding position.

For convertible loan structure, the typical key documents are:

- term sheet;
- convertible loan agreement, which governs the requirements for the disbursement of the funding, key aspects of the loan (such as maturity and interest) and loan conversion mechanism;
- securities documents, which are a set of documents provided by the founders to secure the company's and founders' performances based on the convertible loan agreement with regard to the number of shares that can be obtained by the investors in the intended convertible loan, including shares pledge agreement, call option agreement and power of attorney to sell shares and vote on the founders' behalf; and
- pre-agreed shareholders' agreement, which will be applicable upon the conversion of the loan into shares and the investors becoming a shareholder in the company.

3.5 Investor Safeguards

More venture capital investors are asking for broad-based weighted average anti-dilution in the form of a certain type of compensation for existing investors in the event of a down round in venture capital-funded companies' shareholders' agreements. This was not the norm prior to the COVID-19 pandemic. Some even started asking for full ratchet protection. The use of broad-based weighted average mechanism is more favourable, as a full ratchet mechanism is more draconian in nature. More stringent pre-emption and subscription rights have also become more prevalent.

In terms of winding up or the liquidation process, venture capital investors are usually protected with some liquidation preferences pursuant to the preferred shares held by them. These privileges include the right to receive the liquidation proceeds prior to any payments to the holder of ordinary shares. In a general liquidation process, when a liquidator is appointed to manage the company's assets, the appointed liquidator is under obligation to apply for bankruptcy in the

event that the remaining assets of the company are not sufficient to settle its liabilities, unless there is a contradicting regulation and the company's creditors agree to settle outside the bankruptcy process.

3.6 Corporate Governance

Indonesian company law adopts a two-tier management structure comprising a board of directors (BOD) and a board of commissioners (BOC). The BOD serves the executive function and is responsible for the day-to-day management and operations of the company. The BOC supervises the BOD's duties and the articles of association of the company may require the BOD to obtain prior approval from the BOC before taking certain legal actions on behalf of the company. Both the BOD and the BOC are accountable to the shareholders of the company for their respective roles.

Given the applicable above-mentioned corporate structure, there are several types of influence over management/the affairs of the portfolio company in Indonesia. First, the investor is directly involved in the day-to-day operation of the company through the right to appoint a member of the BOD. Second, the investor has the right to appoint a member of the BOC to supervise the management of the company consisting of the founders sitting as the BOD. Alternatively, the investors may negotiate certain veto for a list of corporate actions that can be taken by the BOD (*"reserved matters"*).

3.7 Contractual Protection

For equity investments, legal recourse for contractual breach is available by law and contractually there are full or partial indemnities for breaches of specifically negotiated representations and warranties or undertakings. Ideally, there should be two types of representations and warranties, covenants and undertakings:

- general terms, such as *"the company has obtained and will continue to maintain all licences, permits and consents from any authority to conduct its operations"* or *"there is no encumbrance over the company's assets"*; and
- specific terms that should be included based on due diligence findings, such as *"the company undertakes to transfer the ownership of the relevant IP from the founder's personal name to the company itself"*.

If the funding is made in the form of loan or convertible notes, investors usually have the right but not the obligation to make all outstanding investment amount and unpaid accrued interest become due and payable. There is also a default interest rate enforceable upon default.

The most commonly seen example of indemnification made by an investee to its investor is the contingent tax liability, whereby the company will pay damages to the new investor when a tax obligation that has been accrued prior to the incoming of the new investor becomes due and payable after the incoming of the new investor.

4. Government Inducements

4.1 Subsidy Programmes

The Indonesian government has been very proactive in incentivising financing in growth companies, ranging from tax incentives, streamlined regulations for start-ups, creating start-up accelerators and even enabling less stringent requirements for growth companies that wish to seek financing through IPO.

4.2 Tax Treatment

Please refer to a tax adviser on this matter.

4.3 Government Endorsement

The OJK has prepared clear initiatives through its 2024-28 roadmap for venture capital companies. Some initiatives may be counter-productive, as the OJK introduced more stringent requirements for equity and corporate governance, which may reduce the number of new venture capital companies – even though this will, in return, increase the oversight and financial soundness of venture capital companies.

Further, the participation of several state-owned enterprises in the venture capital industry (such as the previously mentioned state-backed venture capitalists) could be seen as government initiatives to increase the level of equity financing activities, from the perspective of both the funding amount and portfolio's post-funding life. Those venture capitalists manage the funds from companies listed among the largest asset owners in Indonesia. Moreover, state-backed venture capitalists would be able to integrate their portfolios into their ecosystems with access to the wider market. Through this collaboration, several achievements can be attained, such as:

- the public can enjoy services according to their needs;
- portfolios can grow, leading to subsequent fundraising activities until they become profitable companies; and
- investors can experience economic benefits from the investments made.

Ultimately, the government can indirectly play its role as a facilitator for boosting economic growth.

5. Employment Incentives

5.1 General

Performance-based incentives include offering management/founders stock grants that are tied to company performance. Vesting schedules, where ownership accrues over time, can also encourage key individuals to stay longer to fully benefit from their equity. Key employees may also be bound by other incentives tied to long-term employment, such as tenured bonuses and leaves.

5.2 Securities

The implementation of an Employee Stock Option Programme (ESOP) remains the most-used tool to engage employees' long-term commitment to the company. Commonly, the ESOP is issued with a vesting period requiring the ESOP holder to stay with the company for a certain period of time to receive the shares option in full (usually four years). Moreover, the ESOP is used to incentivise the intended individuals to grow and develop the company so that their stakes resulting from the ESOP exercise will be worthy.

For those individuals owning shares in the company (usually the founders), their shares are commonly tied to the reverse vesting provision under the company's shareholders' agreement. The reverse vesting provision works in the opposite way to an ESOP, whereby the company has the option of repurchasing some of those shares if the intended shareholder (founder) leaves the company during a predetermined period. The duration that the intended shareholder (founder) is required to stay depends upon the company – although, as per ESOPs, the most common requirement is a period of four years.

There are also performance-based stock ownership programmes and tenure-based stock ownership programmes that are designed to encourage management and employees to stay longer in the company and continuously perform.

5.3 Taxation of Instruments

Please refer to a tax adviser on this matter.

5.4 Implementation

As both investment rounds and employee incentive programmes can lead to dilution for existing shareholders, the terms are usually heavily negotiated as a package in a deal rather than negotiated separately. The establishment of an employee incentive programme such as ESOP is commonly done during early-stage funding or subsequent investment rounds. The participating investor in the intended round usually negotiates the pool allocation with management – ie, some percentage in the company's shareholding is allocated to be distributed for the employee incentive programme. Based on such allocation, both the company and its investors would be able to expect the potential dilution on their ownership resulting therefrom.

6. Exits

6.1 Investor Exit Rights

Some exit-related provisions include the investors' rights to direct an IPO or drag other shareholders to sell their shares to a qualified buyer. Commonly, the investors will stipulate a specific timeframe for the company to consider the possibility of conducting an IPO or other exit events in the shareholders' agreement. Once this timeframe has elapsed, the company will be required to appoint a professional adviser to report on exit opportunities and strategy, taking into account the viability and market conditions.

As a precautionary measure in case an IPO is not feasible, usually the investors would wish to have a drag-along right provision in the shareholders' agreement. The right would enable a group of shareholders to force the remaining shareholders in the company to join in the sale of the company. The establishment and implementation of such right can be based on:

- a decision by a group of investors according to the agreed-upon ownership percentage under the shareholders' agreement; or
- whether the sale of company shares meets the agreed-upon valuation criteria under the shareholders' agreement.

The main characteristic of this drag-along right is that all shareholders will sell their shares under the same terms and conditions without any discrimination, including the applicable transfer price.

Transfer restrictions typically include the right of first refusal (ROFR), tag-along right and a certain lock-up period for the founders. These transfer restrictions are also related to the investors' position as minority shareholders in the company, which is very common in the tech start-up world in order to give founders more room to innovate in advancing the company within certain limitations set out by the investors.

With ROFR, the non-transferring shareholders in a company have the right – but not the obligation – to purchase the transferred shares before they are offered to any potential buyers (who are non-existing shareholders). This right gives the non-transferring shareholders the opportunity to maintain their stake and prevent unwanted or undesirable parties from gaining a foothold in the company. Under the prevailing Indonesian

company law, a ROFR provision is not mandatory in companies' articles of association.

A tag-along right provides a right for the non-transferring shareholders to join the sale of shares by a transferring shareholder. Commonly, a tag-along right is granted to minority shareholders to ensure fair treatment in the event of a sale of the company. To avoid confusion, in a ROFR, the right-holder would be able to purchase the transferred shares offered by the transferring shareholder – whereas, in a tag-along right, the right-holder would be able to sell its shares alongside the transferring shareholder.

A founder lock-up is often included in shareholders' agreements to provide stability and continuity to the start-up during critical periods of growth or transition. It is also used to align the interests of founders with other stakeholders and investors, as well as to mitigate the risk of founders exiting the company prematurely.

6.2 IPO Exits

The Indonesian market has experienced two landmark IPOs in the tech start-up industry. Bukalapak, an e-commerce platform, is the first technology unicorn company listed in the Indonesian Stock Exchange (IDX). Bukalapak raised fresh funds of IDR21.9 trillion (approximately USD1.5 billion, according to the applicable currency rate at the IPO), the highest IPO proceeds in the history of the IDX. GoTo raised IDR15.8 trillion (approximately USD1.1 billion, according to the applicable currency rate at the IPO) and was participated in by 300,000 investors, the highest number ever to take part in an IPO on the IDX. These two successful IPOs demonstrate the market's enthusiasm for tech start-up companies' shares, despite the less-than-joyful current stock price developments.

The IDX requires a company to meet one of the following financial criteria in order to list its shares on the Main Board of the IDX:

- profits before tax and net tangible assets for the previous financial year of at least IDR250 billion (approximately USD16.50 million);
- accumulation of profits before tax for the previous two financial years of at least IDR100 billion (approximately USD6.66 million) and share capitalisation value of at least IDR1 trillion (approximately USD66.66 million) before the listing date;
- revenue for the previous financial year of at least IDR800 billion (approximately USD53.33 million) and share capitalisation value of at least IDR8 trillion (approximately USD533.33 million) before the listing date;
- total assets for the previous financial year of at least IDR2 trillion (approximately USD133.33 million) and share capitalisation value of at least IDR4 trillion (approximately USD266.66 million) before the listing date; or
- cumulative cash flow from operating activities for the previous two financial years of at least IDR200 billion (approximately USD13.33 million) and share capitalisation value of at least IDR4 trillion (approximately USD266.66 million) before the listing date.

To assist less-developed companies in going public, the IDX provides avenues in the form of the Development Board and the Acceleration Board, which have easier-to-meet requirements (particularly regarding the company's financial capabilities).

Given that this industry is still new to the Indonesian market, regulators have introduced several specific provisions for tech start-up IPOs. One of them is the introduction of multiple voting shares (MVS), whereby a single share can carry more

than one voting right based on certain tiering thresholds. This new voting share class system evolved from the traditional voting share system, where each share typically holds one voting right or none, and has been adopted by various developed stock exchanges (eg, NYSE, the Stock Exchange of Hong Kong, and Nasdaq).

The primary motive behind implementing MVS is to strike a balance between the development of tech start-ups, which still heavily rely on the vision of their founders, and the interests of shareholders (including public shareholders). With the presence of MVS, founders can maintain their control over the company.

6.3 Pre-IPO Liquidity

There is definitely demand for secondary market trading prior to an IPO but it is unclear whether there is a tangible market need. The main concerns would be existing lock-up and how secondary sales close to an IPO may impact pricing for other non-selling shareholders.

7. Regulation

7.1 Securities Offerings

Anti-dilution provisions would discourage founders from issuing too much equity to employees. Parties will need to structure the ESOP or any securities offering carefully to avoid triggering any public offering requirement. This is usually done by way of grant in Indonesia where no investment decision is available on the part of the employee. Companies also need to bear in mind the number of recipients, so as to avoid being considered a public company.

7.2 Restrictions

A few years ago, the government regulated foreign direct investment (FDI) by implementing something called the *"Negative Investment List"* a list consisting of businesses that are either closed or partially open for foreign investment. Since 2021, the government has reformed FDI policies by implementing something called the *"Positive Investment List"*. In the latest list, more businesses are 100% open for foreign investment, except investment in those classified as closed or partially closed can only be conducted by the government or can only be conducted by micro, small or medium-sized enterprises. The foreign shareholding restrictions may differ depending on the industry – for instance, a local venture capital company is subject to a maximum foreign shareholding of 85%. Companies will also need to adhere to foreign investment and foreign exchange reporting requirements, which may differ depending on investment size and transaction structure.

With this FDI policy, foreign venture capitalists have more opportunity to invest in Indonesian-based tech start-up companies. However, beyond the foreign ownership provisions, a common obstacle is the requirement of IDR10 billion (approximately USD700,000) minimum capital for companies with foreign shareholders (see **3.3 Investment Structure**).

Trends and Developments

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KARNA is an Indonesian law firm focusing on corporate/commercial law as well as litigation and ADR. It provides sophisticated legal counsel to entities of any size and in any stage of development – from burgeoning start-ups to large blue-chip companies – in various practice branches, including M&A transactions, company restructuring, digital economy, private equity/venture capital transactions, content and entertainment, financial services, banking, financing, capital markets, employment, and any other aspects of corporate and commercial law applied in a number of industry fields. The team currently consists of 18 lawyers comprising five partners, 11 permanent associates and two of counsels. To fulfil client global expansion needs, KARNA provides worldwide legal services via the firm's extensive international association network, Withersworldwide. Withers spans the USA, Europe and Asia in order to support clients effectively, with a focus on private individuals and their enterprises. Withers also advises global brands, technology and life sciences businesses, charities and governments.

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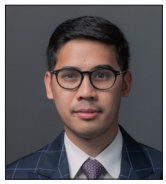

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Introduction

Venture capital (VC) plays a pivotal role in driving innovation and economic growth across South-East Asia. Originating in the United States in the mid-20th century, VC gained momentum through backing from high net worth individuals who supported innovative companies. In essence, VC involves investors providing funding, typically to start-ups or companies in their early to mid-growth phases, in exchange for equity or other forms of return. This type of financing is essential for helping businesses expand their operations, develop new products, and break into new markets. In Indonesia, the conversation around VC trends is largely intertwined with the digital economy, given the heavy concentration of VC investment in the country's tech sector. This article explores the prevailing trends, challenges, and emerging opportunities shaping the VC landscape in Indonesia.

Indonesia's tech start-up investment landscape over the past year has been heavily influenced by the ongoing *"tech winter"*. The funding environment has transitioned from a broad-based, high-volume funding environment to a more selective and quality-driven approach. Investors are now placing greater emphasis on start-ups with solid unit economics and well-defined paths to profitability. In addition, concerns over financial misconduct (eg, as in the case of Investree and e-Fishery) in the management of tech start-ups have also affected investor confidence. Consequently, investors now tend towards increased scrutiny of financial reporting and are calling for greater transparency and accountability.

According to the 2024 e-Economy South-East Asia Report issued by Google, Temasek and Bain & Company, private funding for digital businesses in the South-East Asia region remains subdued, mainly caused by higher interest rate and shifts in the geopolitical landscape. In this *"tech winter"*, investors are more cautious due to macroeconomic uncertainties and are demanding increased downside protection and valuation adjustment or *"rightsizing"*. Fund managers are also preferring business sustainability over a growth-at-all costs approach. As a result, several non-profitable start-ups in Indonesia have struggled to secure funding, leading to mass layoffs and bankruptcy proceedings; and causing some companies with sufficient runway to avoid fundraising due to lower valuation, considering instead alternative financing options including venture debt or conventional bank loans. While

there were relatively sizeable and notable deals, such as the acquisition of GoTo's e-commerce platform, Tokopedia, by the giant social commerce platform from China, TikTok, with a transaction value of around USD1.84 billion and IPO conducted by Mr DIY, a homecare products retail company, with a total raised amount of IDR4.15 trillion (around USD276 million), transactions on the scale of Bukalapak's USD1.5billion raised in its 2021 IPO or GoTo's USD1.1billion raised in its 2022 IPO are no longer as common.

On the positive side, Indonesia benefits from a robust and sizeable domestic market. Many businesses that survived the COVID-19 pandemic have shown strong recovery. The Indonesian government has also taken active steps to support the start-up ecosystem by launching incubation programmes, relaxing exit requirements (including those for IPOs, which will be discussed further in this article), providing tax incentives such as reduced rates for eligible SMEs, and strengthening state-backed venture capital entities. Nevertheless, the industry still faces key challenges, including regulatory hurdles, prominent instances of managerial fraud, limited access to funding, and the competitiveness of local venture capital companies, who must contend with banks, finance companies, foreign venture capital companies, and unregistered domestic players.

These challenges will now be examined in more depth, discussing their impact on investment structures and how VC transactions are typically documented.

Venture Capital Structure

Before deciding on the most suitable structure for venture funding, venture capitalists typically evaluate several key factors, such as their investment goals (including risk tolerance, target returns and exit timeline), applicable regulatory frameworks, tax considerations and prevailing market conditions. The following will examine how these elements influence and shape the optimal investment structure.

Venture capital companies in Indonesia fall under the supervision of the Indonesian Financial Services Authority (*Otoritas Jasa Keuangan*, or OJK). Based on OJK Regulation 25/2023, venture capitalists have the following options to consider:

- venture capital corporation (VCC);
- the newly introduced venture debt corporation (VDC); or
- venture funds.

These choices accommodate different investment strategies and risk preferences, allowing investors to tailor their approach based on their investment goals. VDCs primarily focus on debt and non-equity financing, such as purchasing of notes/bonds issued by start-ups. On the other hand, VCCs focus on equity and quasi-equity financing, such as direct equity participation and purchasing convertible bonds, and can also act as managers of venture funds. Venture funds managed by licensed VCCs pool capital from multiple investors through a collective investment contract to invest in a portfolio of start-ups, diversifying risk and maximising potential returns. VCCs managing venture funds are subject to stricter governance requirements, including the need for an investment manager representative licence and dedicated functions such as risk management, IT and internal audit. While VCCs can engage in financing activities conducted by VDCs, the reverse is not permitted for VDCs seeking direct equity participation.

Furthermore, although the OJK allows other forms of legal entities such as co-operatives and Shariah units, most venture capital companies opt to establish themselves as a limited liability company (*Perseroan Terbatas*, or PT). Only a few operate as Shariah units or Shariah companies. This preference for a PT is because it is a more familiar choice for both foreign and local investors. A PT is generally seen as a more credible business entity and provides limited liability protection to its shareholders, ensuring their personal assets are shielded from the company's debts and liabilities.

Investors should also assess legal restrictions before choosing an investment structure. For example, OJK Regulation 25/2023 restricts venture capital companies from investing directly in non-Indonesian companies without business operations in Indonesia. This requires venture capital companies to focus on local ventures, unlike in countries such as Singapore where these (or similar) limitations do not exist. The regulation also sets a maximum ten-year investment period for direct investments in Indonesian or foreign companies having business operations in Indonesia, and no time limit for convertible bonds. However, if the convertible bonds are converted into equity, the same investment period restriction applies.

A concern often raised by investors when considering obtaining a licence from the OJK is the requirement to have a paid-up capital of IDR50 billion for a VCC or IDR25 billion for a VDC. This means that before starting operations, the shareholders of such applicant must inject this amount. According to the OJK in its 2024–28 roadmap for venture capital companies, many licensed venture capital companies in Indonesia do not have at least IDR50billion in equity, and the equity is mostly concentrated in Jakarta, the current capital city. While the capital requirement serves the purpose of ensuring venture capital companies can sufficiently operate, these challenges may have caused companies lacking funding access to seek financing from unlicensed venture capital companies, conventional alternatives (eg, banking or lending companies) or offshore venture capitalists, particularly those based in Singapore. Due to its geographical proximity, many venture capital companies in Singapore are also managed by Indonesian venture capitalists that are very familiar with the market, making these venture capital companies more accessible for Indonesian businesses.

Another key factor is the imposition of capital gains tax on share sale transactions based on Indonesian tax regulations. Conversely, Singapore does not impose capital gains tax on share sale transactions and withholding tax on dividends for Singapore tax residents. The above factors make a Singapore holding company more appealing for certain investors considering investing in Indonesia. As a result, many start-ups are advised by venture capital companies to establish holding companies in Singapore. However, concerns about transaction and compliance costs remain significant considerations for start-ups. Companies that are just starting may also lack the experience in managing operations across multiple jurisdictions and for companies that need to restructure, there may be potential tax leakages in the restructuring process. Moreover, foreign venture capital companies or holdco looking to invest in Indonesia will also be subject to more regulatory requirements, including foreign shareholding restrictions such as the 85% maximum foreign shareholding for insurance and venture capital businesses (if applicable) and capitalisation requirements. Companies with foreign ownership status (*Perseroan Terbatas Penanaman Modal Asing*, PT PMA) are

required to fulfil a minimum paid-up capital of IDR10 billion (approximately USD700,000). This requirement applies regardless of the amount of investment or shares ownership by foreigners. Not all start-ups are able to meet this requirement at the outset of their establishment. Thus, a thorough assessment of the upsides and downsides mentioned above are necessary before deciding the right investment structure.

Having considered the right investment structure, there will now be a brief overview of the different documentation stages of venture funding, starting from initial investment to exit.

Venture Capital Investment Documentation

In general, the implementation of investments by venture capitals to their potential portfolios, whether tech start-ups or not, typically begins with the issuance of a term sheet containing key provisions regarding the proposed investment. A term sheet typically includes:

- the amount of investment;
- the investment structure;
- the returns received by the investor;
- the prerequisite conditions for investment, including due diligence process;
- the rights to be held by an investor, especially if the investor becomes a minority shareholder in the company; and
- the definitive documents to be executed in connection with the investment.

A term sheet is usually not legally binding on the parties, owing to preliminary requirements that must be fulfilled, including the signing of definitive documents. However, a term sheet may be legally binding when agreed by the parties to protect the interests of investors – for example, through provisions related to exclusivity and confidentiality.

After the term sheet is executed, which can be assumed as the initial step in the investment process, investors will conduct due diligence on the target company. The duration and complexity of the due diligence process will largely depend on the condition of the target company and the industry it operates in. If the company operates in a heavily regulated industry, the due diligence process will need to pay extra attention to compliance aspects. Likewise, if the company has just started, the due diligence will be more limited and more focused on business plans/projections and also the shareholders' arrangement. Essentially, due diligence is conducted to uncover any potential issues within the company.

Once the due diligence process is completed, the parties will negotiate the definitive documents that underlie the investment. These definitive documents will detail the key provisions previously mentioned in the term sheet. Findings from the due diligence may also influence the parties in drafting the definitive documents. Investors may require the target company to address any issues identified during the due diligence process before the investment amount is disbursed. Investors may also request certain warranties from the target company that the issues identified during the due diligence process will not adversely affect the investor upon entering the target company. The definitive documents will also outline the form of accountability in the event of any breaches of representations and warranties made by the target company.

The usual suite of definitive documents for a VC investment (both at VC establishment level or VC funding to a target company) may include:

- constitutional documents that govern the relationship between a venture capital com-

pany and its investors or the venture capital company and its target company;
- a subscription agreement containing the terms for making an investment in a venture capital company or venture fund;
- shareholders' agreement that sets out the rights and obligations of the venture capital company or target company in greater detail;
- a fund management agreement containing terms and conditions for engaging the fund manager (where applicable); and
- side letters where preferential terms may be granted for certain investors.

Minority Protection

When investing in tech start-ups, investors typically hold minority ownership stakes. Majority ownership is initially retained by the founders to grant them flexibility in developing their ideas and innovations for the company's development – though their stakes get diluted over time. Consequently, to ensure that the authority held by the founders is exercised effectively in line with the interests of investors, investors are usually granted minority rights protection.

Indonesian company law adopts a two-tier management structure comprising a board of directors (BOD) and a board of commissioners (BOC). The BOD serves the executive function and is responsible for the day-to-day management and operations of the company. The BOC supervises the BOD's duties and the articles of association of the company may require the BOD to obtain prior approval from the BOC before taking certain legal actions on behalf of the company. Both the BOD and BOC are accountable to the shareholders of the company for their respective roles.

The investors' minority protection can be exercised by regulating matters that require prior investor approval, either as BOC members or shareholders, before they can be carried out by the BOD (commonly known as *"reserved matters"*). The approval threshold also differs per company as a result of negotiations between the parties. Some investors require veto on key matters (eg, new dilutive fundraising) and mostly require majority shareholders' approval. Some of the matters typically addressed in reserved matters include changes in business activities, investment activities, company's expenditures exceeding a certain amount, and other matters (especially those related to amendments in the company's constitutional documents).

The investors' minority rights protections are usually stipulated under a shareholders' agreement, in particular for matters that are not stipulated under Indonesian company law. In addition to the appointment of BOC members to supervise the BOD and reserved matters provision, minority rights protection can be in the form of privileges in a liquidation event, protections in the event of a down round, conversion rights from preferred to ordinary shares, tag-along right, drag-along right, and other forms of protections related to the investors' shareholding, as well as the investors' knowledge regarding company operations. These provisions are material inducements for investors – without which the investment may not proceed – and are at times non-negotiable.

The ideal provisions are those that can be implemented. According to Indonesian law, agreements are binding as long as their contents do not contradict with the applicable laws and regulations. Therefore, even if minority rights protection provisions originate from common law jurisdictions, they can still be enforced in Indonesia. The enforceability of a provision occurs when the right is exercised by its holder. Unfortunately, there are not many company law proceedings in

Indonesia that discussed these provisions – for example, how a shareholder can exercise the drag-along rights to compel other shareholders to sell their shares or how investors are compensated in the event of a down round. Hence, it is difficult to anticipate how Indonesian courts or arbitrations would interpret and apply these provisions in the event of disputes.

Exits

The ease of exiting is a key consideration for investors when entering a new market. Reflecting on the IPO experiences of Bukalapak and GoTo as explained above, IPOs still appear to be an alternative for exit, aside from secondary sales or finding potential buyers to take over the company. IPO discussions naturally revolve around market conditions. Based on data issued by the Indonesia Stock Exchange (IDX) at the end of 2024, the growth of investors on the IDX shows a positive trend, with a recorded number of approximately 15 million investors with single investor identification, where retail investors still hold the highest portion.

The government and IDX are actively supporting companies' IPO efforts, including tech start-ups, by issuing regulations tailored to industry characteristics. One notable regulation is the introduction of multiple voting shares (MVS) allowing a single share to carry more than one voting right based on specific tiering thresholds. This new voting share class system aims to strike a balance between the developmental needs of tech start-ups, which still heavily rely on the vision of their founders, and the interests of shareholders (including public shareholders). With the presence of MVS, founders can maintain their control over the company. Additionally, while requiring companies to achieve certain metrics on profits, revenues, and/or assets for them to be listed on its Main Board, the IDX offers alternative avenues such as the Development Board and the Acceleration Board with easier-to-meet requirements, particularly regarding the company's financial capabilities. Hence, it is easier for tech companies to become public companies.

In addition to the above, recent developments in the industry, including prominent management fraud cases and the establishment of Danantara, will be highlighted in the following sections.

Prominent Management Fraud Cases

Leading tech start-ups such as e-Fishery (agritech) and Investree (peer-to-peer lending) have recently come under investigation for fraud involving inflated assets and revenues, as well as potential embezzlement. Although these incidents do not necessarily reflect the broader management practices of all tech companies, they have nonetheless impacted investor confidence and risk appetite in Indonesia's start-up ecosystem.

Notably, e-Fishery secured USD200 million in funding in 2023, attaining unicorn status, while Investree has raised at least USD230 million to date. These cases have offered important lessons for the Indonesian VC industry, serving as a stark reminder that even well-funded start-ups are not immune to internal fraud or mismanagement.

A key takeaway is the need for robust internal controls, independent audit committees and professionally structured boards, particularly as start-ups grow in scale. Third-party audits and oversight mechanisms could be introduced as early as the growth stage, while still being mindful to provide founders room to implement their vision.

Furthermore, investors should avoid placing excessive reliance on a founder's charisma or vision alone. A more rigorous vetting process, including background checks, conflict of interest assessments and character references, is essential. On the other hand, founders must also build trust by maintaining transparent communication with shareholders, embracing accountability and avoiding blurred lines between personal and company finances or decision-making. Strengthening governance structures is not just good practice – it is vital for sustainable growth and overall investor trust.

Danantara

The establishment of Danantara, a new sovereign wealth fund and investment management institution formed by Indonesia's newly inaugurated government in October 2024, is expected to reshape the country's investment landscape. Danantara's creation and operational mandate are embedded in the significant revision of the State-Owned Enterprises (SOEs) Law under Law No 1 of 2025 (the *"SOEs Law"*). Under this new legal framework, Danantara has been granted the authority to directly enhance and optimise the investments and operations of SOEs. One of the key changes brought about by Danantara's establishment is the reallocation of SOE dividends. Previously channelled into the state treasury, these dividends will now be managed by Danantara to ensure more strategic and efficient utilisation.

Danantara's investment priorities span several critical sectors, including upstream food security, energy security, strategic real estate, and emerging industries such as AI computing and digital infrastructure (eg, data centres, connectivity and fibre optics). These sectors are already attracting significant interest from venture capital (VC) firms, making it plausible for Danantara to co-invest or even take on a catalytic role in VC transactions – similar to the approach adopted by other sovereign wealth funds such as GIC, QIA and PIF.

ITALY

Law and Practice

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Gianni & Origoni is a leading independent international law firm with over 490 lawyers globally, renowned for its expertise in business law. The firm's VC team, comprising 12 professionals based in Rome, Milan, Bologna and London, was established in 2016 through GOP4Venture, focusing on VC and growth investments in start-ups and innovative companies. This initiative integrates M&A expertise with knowledge in intellectual property, joint ventures and fundraising. Its recent work includes advising the founders of Cyber Guru (an Italian security awareness training platform) on a EUR23 million Series B round and assisting the Green Transition Fund (direct fund managed by CDP Venture Capital) with its EUR10 million seed investment round in Arsenale Bioyards. Recently, the VC team also assisted Limolane in expanding its business, including acquiring Asia Car Service and Service Vill. The team also supported Limolane in selling a minority stake to Cherry Bay Capital Group, in a EUR35 million financing round. Lastly, it assisted Azimut with a EUR40 million investment in Alps Blockchain Spa, a leader in blockchain R&D and mining.

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1. Trends

1.1 VC Market

Over the past 12 months, several landmark VC transactions in Italy have shaped the country's innovation landscape. In the tech space, Bending Spoons, a leading app development company, secured EUR143 million in 2024, reflecting strong investor confidence in Italy's growing tech ecosystem. The medical and biotech sectors also saw significant funding, with Medical Microinstruments (MMI) raising EUR101 million in a Series B round to expand its robotic surgery technology. Similarly, Genespire, a biotechnology firm focused on gene therapy, raised EUR46.6 million, further highlighting interest in healthcare innovations.

In fintech, Satispay, Italy's prominent mobile payment platform, secured EUR60 million to scale its operations across Europe, driven by the rising demand for digital financial solutions. Another significant funding round took place in the mobility sector, where LimoLane, a B2B mobility scale-up, closed a EUR35 million round in July 2024. The funding, supported by Cherry Bay Capital Group, FG2 Capital and private investors, will help fuel LimoLane's organic growth and a buy-and-build strategy in the industry.

Among notable exits, D-Orbit, an aerospace company focused on space logistics, strengthened its position through a significant funding round, garnering attention in the global space industry. Additionally, the partnership between OpenAI and Cassa Depositi e Prestiti (CDP), Italy's state investment fund, is worth noting. This collaboration aims to integrate AI technologies into Italian start-ups, signalling a shift in VC dynamics and national efforts to drive innovation.

These milestones highlight Italy's vibrant VC environment and the increasing global interest in its emerging sectors.

1.2 Key Trends

Over the past 12 months, the Italian VC market has experienced several notable trends, shaped by the global investment climate. The most significant trend has been a tightening of financing conditions, driven by broader economic uncertainty and a globally subdued VC market. Investors have become more cautious, focusing on companies with proven business models and stable growth trajectories. Early-stage funding rounds have become more selective, with higher due diligence standards and a stronger emphasis on profitability over rapid growth.

Transaction structures have also evolved in response to these market conditions. There has been an increased use of milestone-based financing, where investors commit capital in tranches tied to the achievement of specific operational or financial milestones. This structure mitigates risk and ensures that capital is deployed efficiently as companies meet key growth targets.

In terms of deal terms, there has been a clear shift towards more investor-friendly provisions. Valuations have seen a downward adjustment, and down rounds (where start-ups raise capital at a lower valuation than in previous funding rounds) have become more common. Additionally, the use of liquidation preferences has increased, allowing investors to secure priority returns in case of an exit event, reflecting heightened risk aversion. Anti-dilution clauses have also become more prevalent, ensuring investors' equity stakes are protected in future funding rounds.

In light of these trends, Italian start-ups are increasingly required to demonstrate resilience and a clear path to profitability to attract investment, and deal terms are becoming more heavily weighted in favour of investors, reflecting the global investment climate's more conservative stance.

1.3 Key Industries

In the past 12 months, the Italian VC market has been primarily driven by industries such as fintech, life sciences, AI and sustainability. These sectors have attracted significant investor interest, with fintech and AI seeing robust funding due to the increasing demand for digital payments and data-driven solutions. Life sciences, particularly biotech and medtech, also remain strong, with innovation in healthcare technology fuelling investments.

The fintech and software sectors have been key drivers. Milan led fintech investments, attracting EUR4.1 billion between 2020 and 2024, constituting 76% of regional capital.

A clear distinction can be drawn between industries with higher VC-backed exits and those that experience a greater number of financing rounds. Life sciences and technology sectors, especially those with more mature companies, tend to see more exits, as start-ups often progress to acquisitions or public listings once they achieve scalability. These industries typically have clearer exit strategies once their products reach market maturity.

In contrast, sectors like fintech, AI and sustainability often see increased financing rounds. Start-ups in these industries tend to require multiple funding stages to scale their operations, refine their offerings, and extend their market reach. The nature of these sectors often demands ongoing investments before considering exits, as the companies are still in a phase of rapid growth and technological development.

Thus, while some industries are geared toward exits after reaching certain milestones, others remain focused on continuous funding to support their expansion and innovation. This trend reflects the different growth stages and investment strategies across sectors in Italy's evolving VC landscape.

2. Venture Capital Funds

2.1 Fund Structure

In Italy, VC funds are typically structured as closed-end investment funds (*Fondi chiusi*), established and managed by an asset management company (SGR – *Società di Gestione del Risparmio*) authorised by the Bank of Italy and supervised by both the Bank of Italy and CONSOB. The fund itself is not a legal entity, but a separate pool of assets held by the SGR in the exclusive interest of investors.

The legal framework is primarily governed by the Italian Consolidated Law on Finance Legislative Decree No 58/1998 (*Testo Unico della Finanza* TUF) and Bank of Italy regulations, which set out rules on fund formation, management and operations. The fund's governance and investment process are defined in the Fund Rules (*Regolamento del Fondo*), a key corporate document approved by the SGR and filed with the regulator. The Fund Rules establish the fund's investment strategy, duration, fees, governance bodies and decision-making processes, including the role of the Advisory Committee, often composed of representatives of cornerstone investors, which provides non-binding opinions on conflicts of interest and key transactions.

Decision-making is typically centralised within the SGR, which exercises full discretion over investment and divestment decisions, though internal investment committees and advisory bodies may be involved for strategic guidance or investor alignment.

Market-standard fund documentation includes the fund rules, the investment management agreement (if outsourced), and subscription agreements with investors, often incorporating limited partner (LP)-style terms adapted to the Italian regulatory context. Increasingly, Italian venture funds adopt international best practices – such as those inspired by the Institutional Limited Partners Association (ILPA) Principles – to ensure alignment of interests and transparency with institutional investors.

2.2 Fund Economics

In Italy, fund initiators, managers or principals typically participate in the economics of VC funds through management fees, carried interest and personal co-investments. Management fees, usually ranging from 1.5% to 2.5% of committed capital, cover operational expenses. Carried interest, typically around 20%, entitles fund principals to a share of the profits once a preferred return (or hurdle rate) is achieved for investors. Increasingly, fund managers are required to commit their own capital – known as general partner (GP) commitment – aligning their interests with those of limited partners.

Over time, key market-standard terms have evolved to strengthen investor protection and governance within Italian VC funds. Investor advisory committees are commonly established, granting limited partners oversight rights on conflicts of interest, valuation methodologies and material fund decisions. These committees also review related-party transactions and extensions of fund life, reinforcing transparency.

Preferred return structures or hurdle rates have become standard, ensuring investors receive a minimum return before managers participate in profits. Claw-back provisions are also typical, requiring managers to return excess carried interest if fund performance drops below target levels after early distributions.

Governance provisions now emphasise strong reporting obligations, quarterly updates and detailed disclosures to investors. Compliance with eESG principles is increasingly embedded in fund documentation, reflecting both investor expectations and alignment with EU sustainability regulations. Together, these mechanisms balance the entrepreneurial incentives of fund principals with robust investor protections in Italy's VC landscape.

2.3 Fund Regulation

VC funds in Italy are typically structured as closed-end alternative investment funds (AIFs) and are subject to specific regulation under both Italian law and the European Alternative Investment Fund Managers Directive (AIFMD). Italian VC funds are commonly established as *Fondi di Investimento Alternativi* (FIAs), governed by the TUF and overseen by the Italian financial regulator, CONSOB, as well as the Bank of Italy for prudential supervision.

Fund managers must obtain authorisation as AIFMs if they exceed certain asset thresholds, requiring them to comply with stringent reporting, risk management and transparency obligations. Smaller funds may benefit from lighter regulatory requirements if they fall below AIFMD thresholds. Additionally, funds' marketing to

retail investors face further restrictions and obligations to ensure investor protection.

Funds investing in innovative start-ups or SMEs may also qualify for favourable tax treatment or government-backed initiatives, subject to additional compliance requirements. For example, funds targeting sectors relevant to national interests might be scrutinised under Italy's foreign direct investment (FDI) rules.

Unlike mutual funds, VC funds are generally illiquid and operate with defined investment periods and lock-up structures. Their governance framework often includes an advisory committee composed of investors to oversee conflicts of interest, valuation and major decisions.

Overall, Italy's regulatory environment for VC funds aligns with European standards but incorporates specific domestic requirements reflecting the country's efforts to promote innovation while safeguarding investors.

2.4 Particularities

The Italian VC environment has matured in recent years, characterised by increased government involvement, the rise of impact funds and fund-of-funds activity. Notably, the Italian National Innovation Fund (*Fondo Nazionale Innovazione*) and various regional programmes have significantly increased government-backed VC investments. These initiatives aim to stimulate start-up growth, particularly in strategic sectors like digitalisation, sustainability and healthtech.

Impact investing is gaining traction, with several funds dedicated to ESG-aligned ventures or social impact projects, reflecting broader European trends toward sustainable finance. Additionally, fund-of-funds structures are increasingly used to diversify risk and broaden market exposure, allowing institutional investors to participate indirectly in the VC space while minimising concentration risk.

Given Italy's traditionally longer holding periods and limited exit options – especially IPOs –, funds have adapted their strategies to maintain flexibility. Continuation funds or secondary sales to new funds have emerged as mechanisms to manage portfolio companies requiring longer maturation without forcing premature exits. Some funds also build in extension options, allowing the fund life to be prolonged to accommodate delayed exits or market downturns.

Moreover, government incentives have encouraged pension funds to allocate capital to VC, further supporting fund growth and liquidity. As the market evolves, Italian VC funds are increasingly incorporating flexible exit strategies, impact-focused investments, and hybrid structures to adapt to longer investment horizons and the specific challenges of Italy's venture ecosystem.

3. Investments in Venture Capital Portfolio Companies

3.1 Due Diligence

In Italy, VC investors typically conduct a thorough due diligence across several key areas to assess both the potential and risks of a start-up. The standard due diligence process covers legal, financial and technical aspects, with each area focusing on different critical factors.

Legal due diligence focuses on reviewing the company's corporate structure, governance frameworks and contracts, including shareholders agreements. A key area of concern is intellectual property (IP); investors assess whether IP rights are properly registered and whether any

legal disputes exist. Unresolved legal issues, such as ongoing litigation or imbalanced governance structures, can be major red flags.

Financial due diligence involves a deep dive into the company's financial health, reviewing financial statements, tax filings and projections. Investors focus on identifying inconsistencies in financial reporting, excessive liabilities or unrealistic revenue forecasts. Any lack of transparency or accounting irregularities could raise significant concerns about the company's financial integrity. The clarity and accuracy of financial data are crucial for building investor confidence.

Lastly, technical due diligence is particularly important for start-ups in the technology and biotech sectors. Investors evaluate the company's technology, product development progress and IP portfolio. Red flags include unproven or incomplete technology, reliance on immature products or an inadequate technical team. If the technology is easily replicable or lacks a competitive edge, it can undermine the start-up's potential for long-term success.

Together, these three areas of due diligence help investors evaluate whether a start-up is a sound investment or presents significant risks.

3.2 Process

In Italy, the timeline for a new financing round involving new anchor investors in a growth company typically spans three to six months, though complexity or negotiation intensity may extend it. The process unfolds through preliminary discussions, term sheet negotiation, due diligence and the finalisation of binding agreements, often involving notarial execution for share or quota transfers, particularly in S.r.l. (*Società a Responsabilità Limitata*) structures. Regulatory filings may add further time, especially if foreign investors or cross-border elements are involved.

The dynamics between existing and new investors can be delicate. New anchor investors often demand priority rights, requiring adjustments to existing agreements, including anti-dilution protections or exit rights. Existing investors may push back, particularly if the new terms risk diluting their position or influence. Aligning interests often results in intense negotiations.

Regarding legal representation, it is common for investors – especially new ones – to appoint separate counsel to avoid conflicts of interest, while companies may have independent advisors.

However, smaller deals or well-aligned syndicates may share counsel for efficiency.

Consent requirements are usually governed by shareholders' agreements. Major corporate decisions, such as approving a new round, often require supermajority votes or unanimous consent for protective matters. Pre-emptive rights of existing investors, if not waived, may complicate new investments, requiring careful legal structuring to balance majority rule with individual investor protections. Overall, reaching alignment across investor classes is a key factor influencing the timeline and success of a round in Italy.

3.3 Investment Structure

In Italy, VC investments often involve instruments other than common stock equity. These include special quotas in S.r.l. structures, as well as quasi-equity instruments like SAFEs (Simple Agreements for Future Equity) and convertible loans.

The S.r.l. structures allow the creation of either quotas conferring special rights or different classes of quotas, each with distinct rights. Investors typically receive preferred quotas, which provide rights such as liquidation preferences (ensuring investors are paid before common quotas in the event of liquidation), preferential dividends (usually on a cumulative basis) and anti-dilution protections (eg, full ratchet or weighted average provisions). Voting rights for preferred quota holders are often limited but may include veto powers over significant corporate decisions. The flexibility of the S.r.l. structure makes it a common choice for VC-backed companies, enabling tailored governance and investor rights.

In addition to equity-like instruments, quasi-equity instruments are increasingly used, especially in early-stage financing. SAFEs allow investors to provide capital without determining an immediate valuation. These agreements convert into equity when certain conditions are met, such as a future funding round. SAFEs are particularly popular for seed-stage investments because they simplify the investment process. While KISS (Keep It Simple Security) agreements are also an option, in Italy they are less common than SAFEs.

Another widely used instrument is the convertible loan, which allows investors to provide funds that can later be converted into equity, typically at a discount or with a valuation cap. These instruments are common in early-stage financing, providing flexibility and rewarding early-stage risk.

These structures help investors secure preferential rights while providing start-ups with flexible funding options.

3.4 Documentation

In Italy, the key documents typically involved in a financing round for a growth company include the following.

- Term sheet: this non-binding document outlines the preliminary terms of the investment, including valuation, investment size, investor rights and other key provisions. It serves as a foundation for final agreements and is often used as a basis for negotiations. While not universally binding, it helps set expectations and guide the drafting of final legal documents. Templates provided by industry associations like AIFI (Italian Private Equity and VC Association) are commonly used, particularly in seed and early-stage deals, though customisation is often required.
- Due diligence report: this report is prepared during the due diligence process and helps investors assess the risks and opportunities of the investment. It covers legal, financial and technical evaluations of the company.
- Investment agreement: This binding agreement finalises the terms of the investment, including investor commitments, liabilities, and other specific conditions that apply to the investment.
- Shareholders' agreement: a legally binding document that outlines the rights and obligations of shareholders, governance, decision-making processes and exit strategies. In Italy, it must comply with the Italian Civil Code, specifically regarding shareholder voting rights and exit mechanisms. The agreement also addresses pre-emption rights, allowing existing shareholders the first opportunity to buy additional shares before third parties.
- Articles of association: this constitutional document governs the company's operations, shareholder rights and internal rules, and must align with Italian law.

In Italy, while standard templates are frequently used, particularly in early-stage deals, the specifics of each deal often lead to customised agreements. Major law firms often create their own templates based on their experience with VC transactions.

3.5 Investor Safeguards

In Italy, VC investors typically negotiate strong downside protections to secure priority over founders, employees and junior stakeholders in adverse scenarios like liquidation or winding up. Liquidation preferences are standard, ensuring that investors recover their capital, sometimes with a multiple, before common shareholders receive proceeds. Participating liquidation preferences, allowing investors to recover their investment plus share remaining proceeds, are becoming more common, especially in uncertain market conditions.

Anti-dilution protections are a well-established market standard in Italy, particularly in early and growth-stage deals. They are typically structured as either full ratchet or weighted average provisions. Full ratchet clauses fully adjust the investor's price to the lowest subsequent round price, while weighted average provisions offer a more moderate adjustment based on the volume and price of the new issuance. These clauses are triggered by down rounds where new shares are issued at a lower valuation.

Pre-emption or subscription rights over new shares are also common and contractually agreed in shareholder agreements, giving investors the option to maintain their pro-rata ownership in future rounds. Such rights are critical in an ecosystem where exits are less frequent, and ownership dilution is a major concern.

Recent market volatility has led to tougher investor terms, including more prevalent participating liquidation preferences, compounded preferred returns and stricter anti-dilution clauses. These reflect investors' increased risk sensitivity and desire for better downside protections in Italy's still-maturing venture market.

3.6 Corporate Governance

In Italy, VC investors typically secure meaningful influence over management and corporate governance through both formal board representation and contractual rights in shareholders' agreements. Investor-nominated board seats are common, particularly from Series A rounds onward, enabling direct involvement in strategic decisions and oversight of management. Investors often negotiate for veto rights over specific material actions, such as issuing new equity, altering the business plan, acquiring or selling significant assets, changing corporate governance structures, or hiring and firing key executives.

Shareholder agreements frequently define these governance rights, balancing investor protections with operational flexibility. These rights may include consent requirements for extraordinary transactions, dividend distributions, changes to company by-laws or capital increases. For S.r.l. structures, particular attention is paid to drafting powers in the by-laws to ensure enforceability under Italian civil law, where quota transfers or special rights require explicit statutory regulation.

Additionally, information rights allow investors to access regular financial reports, budgets and strategic updates. In some cases, investors obtain observer rights on the board, enabling participation without formal voting power, especially when they do not hold a board seat.

While founders retain operational control in most cases, Italian market practice increasingly reflects a balanced power structure where investors protect their financial interests and strategic influence, especially in later-stage companies. This alignment is critical in the relatively illiquid Italian market, where investors seek assurance that their capital is managed prudently.

3.7 Contractual Protection

In Italian VC financings, representations and warranties typically cover corporate organisation, capitalisation, intellectual property ownership, compliance with laws, financial statements accuracy and the absence of undisclosed liabilities. Founders and the company guarantee that all material information disclosed to investors is true, complete and not misleading, providing a basis for investor trust and legal recourse.

Covenants and undertakings also form a core part of the agreements, committing the company to maintain proper governance, avoid unauthorised debt or asset sales and protect intellectual property. Negative covenants may restrict certain actions without investor consent, while affirmative covenants require regular reporting and compliance with business plans.

Remedies for breach usually involve indemnification, where the breaching party compensates investors for losses directly resulting from misrepresentations or covenant violations. Liability caps are common, limiting the financial exposure of founders and the company, often up to a percentage of the investment or total deal value. Disclosure schedules appended to agreements allow the company to list known exceptions, limiting liability if previously disclosed.

In severe breaches, remedies may include rescission of the agreement, forced repurchase of shares or adjustments in equity stakes. Italian practice typically favours negotiated settlements but allows for litigation or arbitration where disputes cannot be resolved. Given Italy's legal framework, careful drafting of these provisions is crucial to ensure enforceability, especially when balancing founder liability and investor protection.

4. Government Inducements

4.1 Subsidy Programmes

Italy offers several government and quasi-government programmes aimed at incentivising equity financing in growth companies, particularly for start-ups and SMEs. Key initiatives include the following.

- *Fondo Nazionale Innovazione* (National Innovation Fund): a state-backed VC fund that co-invests with private investors, reducing the risks associated with early-stage ventures. This fund supports innovative companies, particularly those in high-tech sectors, contributing to the overall growth of the Italian start-up ecosystem.
- Angel Investor Tax Credit: this programme provides tax credits of up to 30% for investments in eligible start-ups. It encourages individual investors to support early-stage companies, especially in sectors like tech, biotech and green innovation.
- Smart&Start Italia: this initiative provides grants and loans to innovative start-ups across Italy, especially in regions less prone to VC investments. It helps overcome financial barriers to innovation and encourages business creation.
- Euronext Growth Milan: formerly known as AIM Italia, Euronext Growth Milan is a market tailored to dynamic SMEs seeking capital to

fuel their growth. It offers a simplified listing process, lower access requirements, and ongoing guidance from a Euronext Growth Advisor. This market is particularly beneficial for companies that need access to capital but are not yet ready for a full-scale IPO.

These government programmes, combined with the support provided by Euronext Growth Milan, create a strong environment for attracting VC and equity financing to innovative Italian companies.

4.2 Tax Treatment

In Italy, the tax treatment of investments in growth, start-up and VC fund portfolio companies is characterised by significant incentives that deviate from the general corporate tax regime. These measures are specifically designed to encourage investments in innovative businesses and strengthen the country's entrepreneurial ecosystem.

Equity investments in qualifying innovative start-ups and SMEs benefit from tax deductions, allowing individuals and corporations to offset up to 30% of their investment annually. From 2025, individuals will access a 65% deduction for investments up to EUR100,000 per year under the de minimis regime, although this enhanced benefit will no longer apply to innovative SMEs. A further deviation from the general regime is the full capital gains tax exemption available for qualifying investments made between June 2021 and December 2025, provided the investment is held for at least three years. This exemption applies only to investments eligible for the 30% deduction and does not extend to de minimis investments.

Certified incubators and accelerators investing in start-ups can also benefit from an 8% tax credit, capped at EUR500,000 annually, provided the investment is maintained for three years. Additionally, pension funds face new obligations from 2025, with mandatory allocations to VC funds reaching 10% by 2026. Non-compliance results in the loss of certain tax exemptions, further illustrating the state's effort to channel capital into innovation.

For debt investments, interest income is generally subject to a 26% withholding tax for non-resident investors, although treaty relief may apply. Convertible instruments may, in some cases, qualify for capital gains treatment if structured appropriately. Equity-based incentive schemes such as stock options also enjoy favourable tax treatment, particularly within innovative start-ups, offering exemptions or deferrals that are not available under the standard rules.

4.3 Government Endorsement

The Italian government has implemented several material initiatives to increase equity financing activity, particularly in the start-up and SME sectors.

- Scale-up Act (Law 193/2024): enacted in December 2024, this Law introduces new incentives to enhance the start-up ecosystem, including expanded tax breaks and support for emerging sectors like AI, blockchain and green technology. It aims to make Italy more attractive for equity investors by simplifying regulations and offering more financial incentives.
- EU funding access: Italy's participation in EU programmes like Horizon Europe and InvestEU provides Italian start-ups with access to significant cross-border funding. This strengthens Italy's position in the European equity financing landscape, particularly in research-driven sectors.

- Patent Box and super-depreciation: tax incentives like the Patent Box and super-depreciation schemes encourage companies to invest in R&D and innovation. These initiatives reduce tax burdens and make investments in equity more attractive, especially for tech and biotech sectors.
- Euronext Growth Milan: this market continues to provide a platform for SMEs seeking growth capital. The simplified listing process and tailored regulatory support offer an attractive option for companies to access equity financing while benefiting from ongoing advisory support. This has become a crucial tool for expanding equity financing options for growing companies in Italy.

These measures, along with continuous improvements in tax and regulatory frameworks, aim to increase equity financing activity and promote Italy's growing start-up ecosystem

5. Employment Incentives

5.1 General

In Italy, the long-term commitment of founders and key employees is typically ensured through a combination of contractual obligations and incentive mechanisms. A common approach is the inclusion of reverse vesting clauses in shareholder agreements, which link ownership of equity or quotas to continued involvement in the business. Under reverse vesting, founders may initially hold shares or quotas, but risk losing part of them if they leave the company before a specified vesting period ends. This structure ensures alignment between the founders' interests and the company's growth trajectory.

Good leaver and bad leaver provisions are also widely used. These define the financial and legal consequences if a founder or key employee departs voluntarily, is dismissed for cause, or breaches their obligations. A bad leaver typically forfeits part of their equity or must sell it back at a discounted price, while a good leaver may retain their rights or sell their stake at fair market value.

Non-compete and non-solicitation clauses often reinforce these mechanisms, preventing founders from immediately competing with the company or poaching clients or employees upon departure. These clauses are structured within Italian employment law and civil law frameworks, ensuring enforceability while protecting the business.

Overall, the goal is to align personal incentives with long-term company success, minimise disruptive departures, and secure investor confidence that the founding team will remain fully engaged throughout the critical growth phases.

5.2 Securities

In Italy, equity-based instruments are commonly used to incentivise founders and key employees, with stock option plans, work-for-equity schemes, and, less frequently, phantom shares serving as standard tools. These instruments grant rights to acquire equity under certain conditions, aligning individual rewards with the company's success.

Stock option plans are structured to allow participants to purchase company quotas or shares at a predetermined strike price, typically lower than market value, after meeting vesting conditions. Reverse vesting schedules are widely used, tying ownership rights to continued service over several years. If a founder or employee leaves before full vesting, part of the granted options or equity may be forfeited or bought back at a

reduced price. Vesting often follows a linear or milestone-based schedule, with typical terms ranging from three to five years.

Work-for-equity arrangements, specifically regulated for innovative start-ups, permit companies to issue equity in exchange for services, often under favourable tax conditions. This scheme strengthens ties between talent and company growth while reducing immediate cash outflows.

Phantom shares, though less common, offer economic benefits similar to equity without transferring ownership. These plans are typically linked to performance milestones or exit events and are paid out in cash.

Exercise periods and terms vary but commonly provide a window post-vesting, often until an exit event, within which options can be exercised. Italian civil law requires that these mechanisms, especially within S.r.l. structures, be carefully drafted to comply with notarial requirements for quota transfers and the rules on special rights.

5.3 Taxation of Instruments

In Italy, structuring employee incentive schemes is heavily influenced by tax considerations, particularly the timing of taxable events and applicable tax rates. Generally, equity-based incentives, such as stock options or work-for-equity schemes, are taxed at the moment of exercise or realisation, rather than at the grant date. This means taxation arises when the employee exercises the option or sells the resulting shares, aligning tax liability with liquidity events.

For standard stock options, the difference between the exercise price and the market value at exercise is treated as employment income and taxed under progressive income tax rates (IRPEF), which can reach up to 43%. Social security contributions may also apply at the exercise stage, further increasing the cost for employees.

However, innovative start-ups benefit from preferential tax treatment under Italy's specific regulations. If structured correctly, stock options granted by qualifying start-ups may be exempt from income tax and social security contributions at exercise, provided certain conditions are met – such as holding periods and non-transferability of the options until an exit. This exemption shifts taxation to the capital gain realised upon the sale of shares, generally subject to a 26% flat rate, a significant tax advantage compared to ordinary income treatment.

These tax rules greatly influence the size, timing and structure of incentive pools. Companies and investors often prioritise schemes eligible for favourable treatment, balancing the need to attract talent with the goal of minimising tax burdens for both the company and the beneficiaries.

5.4 Implementation

In Italy, the implementation of an investment round and the establishment of an employee incentive programme are closely connected, both from a procedural and dilution standpoint. Typically, incentive plans are negotiated or adjusted during investment rounds, especially when new investors enter the company. Investors often require the incentive pool to be defined and sized upfront to account for potential dilution, ensuring clarity on post-investment ownership structures.

From a process perspective, the creation or expansion of an incentive pool often forms part of the capital increase approved during the funding round. The shareholders' meeting, usually

held before a notary, formally approves both the investment and any reserved share or quota allocations for the incentive scheme. This approach ensures legal compliance, especially within S.r.l. structures, where quota transfers and rights must be explicitly codified.

Dilution is a key concern addressed during negotiations. Investors frequently request that the incentive pool be calculated on a fully diluted basis, meaning it is considered as already issued when determining their percentage ownership. This shields new investors from unexpected dilution later if the incentive pool expands.

The timing also reflects practical considerations. Incentive plans are often installed immediately after closing, allowing key personnel to benefit from the uplift in company value brought by the new funding. Founders and early employees may also renegotiate their existing rights as part of the round, ensuring alignment between equity incentives, company growth and new investor expectations.

This interplay ensures incentive mechanisms are fully integrated into the cap table, balancing motivation for the team with investor protection against future dilution.

6. Exits

6.1 Investor Exit Rights

In Italy, VC investments are typically governed by shareholders' agreements that include exit-related provisions such as drag-along and tag-along rights, designed to protect both majority and minority shareholders in a liquidity event like a trade sale or IPO. Drag-along rights enable majority shareholders to force minority holders to sell their stakes upon an agreed exit, ensuring a clean sale to a buyer. Conversely, tag-along rights protect minority investors by allowing them to join any sale initiated by majority shareholders under the same terms.

Transfer restrictions are common and primarily serve to control the entry of new shareholders and preserve the company's strategic direction. Standard mechanisms include lock-up periods, rights of first refusal and rights of first offer. These provisions limit the free transfer of quotas or shares, requiring approvals or offering the existing shareholders priority purchase rights.

Exit triggers are typically defined by events such as a qualified trade sale, IPO or other liquidity events, including changes in control or specified financial milestones. Given Italy's historically limited exit environment – particularly fewer IPOs and strategic sales compared to other European markets – market practice has adapted. Investors increasingly negotiate specific exit rights, including redemption rights or put options, providing a contractual path to liquidity if no external exit materialises within a certain timeframe. This reflects a pragmatic response to the scarcity of exit opportunities, offering investors alternative mechanisms to secure returns while aligning expectations among all shareholders.

6.2 IPO Exits

In Italy, IPO exits remain relatively rare for start-ups compared to other European markets. The limited size of the Italian capital markets, combined with a more risk-averse entrepreneurial culture, contributes to fewer companies reaching the scale or maturity required for a traditional stock exchange listing. As a result, trade sales, secondary sales and private equity acquisitions are more frequent exit routes for Italian venture-backed companies.

When start-ups do pursue an IPO, the timing is typically driven by revenue growth, market traction and investor readiness rather than fixed timelines. Companies seek to establish profitability or at least demonstrate a clear growth trajectory to meet listing requirements and attract institutional investors.

Among listing venues, the Euronext Growth Milan (EGM) (formerly AIM Italia) is the most commonly chosen platform for start-ups and growth companies. EGM offers simplified access rules, reduced regulatory burdens, and lower costs compared to the main Italian Stock Exchange (*Borsa Italiana*). This venue targets dynamic small and medium-sized enterprises (SMEs) seeking capital for expansion without undergoing the full compliance requirements of a regulated market.

Offering structures often involve a mix of new share issuance to raise capital and partial exits by existing shareholders. However, the limited liquidity and lower investor appetite for small-cap stocks in Italy continue to make IPOs a less prevalent exit choice, with many companies viewing them as a long-term goal rather than a primary strategy.

6.3 Pre-IPO Liquidity

There is a tangible but still developing market need for secondary liquidity mechanisms in Italy, especially given the relatively infrequent IPOs and strategic exits. Founders, early employees and seed investors often seek partial liquidity before a formal exit, particularly as start-ups scale and raise successive funding rounds. However, the fragmented nature of the Italian venture ecosystem and regulatory complexities have limited the widespread development of structured secondary market programmes.

Key challenges include the legal structure of Italian companies, particularly S.r.l., where quotas are not freely transferable and often require notarial deeds for transfers. This creates procedural and cost barriers to establishing efficient secondary trades. Furthermore, contractual transfer restrictions such as rights of first refusal, lock-up periods, and pre-emptive rights can complicate or delay liquidity events, requiring careful navigation of existing shareholders' agreements.

Legally, any structured liquidity programme must respect these internal company rules, Italian civil code provisions and applicable financial regulations if securities are involved. Such programmes typically require tailored amendments to shareholder agreements, explicit waivers of certain rights and possibly the creation of special purpose vehicles or buyback schemes facilitated by the company itself.

Company-facilitated tender offers are one of the few tools that have gained some traction, especially in later-stage companies. They allow the company or new investors to repurchase shares from early stakeholders, providing liquidity while maintaining control over the cap table. However, their use remains relatively limited and ad hoc, reflecting the need for further market maturation and regulatory clarity around secondary transactions in Italy's venture landscape.

7. Regulation

7.1 Securities Offerings

In Italy, the offering of a company's equity securities in a VC transaction is governed primarily by the Italian Civil Code, the TUF and the relevant corporate regulations, particularly when dealing with significant transactions or numerous employees and entitlement holders.

For private companies, especially S.r.l., equity offerings are largely governed by private contractual agreements and shareholder resolutions. Any issuance of new quotas requires approval by the shareholders' meeting, notarisation and registration in the Companies Register. The transfer of quotas is also subject to restrictions typically set out in the company's by-laws or shareholder agreements, including rights of first refusal and lock-up clauses.

In more sizeable transactions or where employees are entitled to equity participation, public offering regulations may come into play. If the offering qualifies as a public solicitation of investment – typically when it is addressed to more than 150 non-professional investors – the company must comply with the prospectus requirements under TUF and EU Prospectus Regulation unless specific exemptions apply. These rules aim to protect retail investors and ensure transparency but usually exclude offers made to professional investors or employees under approved stock option plans.

Where equity is offered broadly to employees, specific labour and tax rules apply, particularly regarding stock option schemes and work-for-equity plans in innovative start-ups. These structures benefit from streamlined processes and tax incentives but still require compliance with Italian employment laws and proper documentation.

Therefore, while private VC transactions often remain outside public offering regulations, the scale of the transaction and the number of beneficiaries may trigger additional legal obligations, making careful legal structuring essential.

7.2 Restrictions

Foreign VC investment in Italian portfolio companies is generally permitted, but certain legal and regulatory restrictions may apply depending on the sector and structure of the transaction. Italy does not impose general currency exchange controls on foreign investors; capital can be freely transferred in and out, consistent with EU principles on free movement of capital. However, banking regulations prohibit non-licensed entities from performing activities reserved for financial intermediaries, such as collecting third-party savings or offering certain financial services without proper authorisation.

The most significant restriction arises from Italy's FDI screening regime, known as the *"Golden Power"* regulation. This framework allows the Italian government to review and potentially block investments by foreign investors, including EU investors, in strategic sectors such as defence, energy, telecommunications, critical infrastructure, health, financial services and AI. Venture investments targeting start-ups operating in these sectors may trigger mandatory notifications and governmental clearance. Failure to comply can result in fines or even the nullification of the transaction.

Over the past 12 months, geopolitical tensions and increasing EU-wide scrutiny of foreign investments, particularly from non-EU countries, have led Italy to expand the scope of its FDI rules. Enhanced enforcement and lower thresholds for review mean that even minority VC stakes in sensitive sectors may now face scrutiny. This trend reflects broader European concerns about protecting strategic industries from foreign influence. As a result, foreign VC investors must conduct thorough regulatory checks and factor potential Golden Power implications into their transaction planning, especially in tech-heavy or regulated sectors.

Trends and Developments

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Gianni & Origoni is a leading independent international law firm with over 490 lawyers globally, renowned for its expertise in business law. The firm's VC team, comprising 12 professionals based in Rome, Milan, Bologna and London, was established in 2016 through GOP4Venture, focusing on VC and growth investments in start-ups and innovative companies. This initiative integrates M&A expertise with knowledge in intellectual property, joint ventures and fundraising. Its recent work includes advising the founders of Cyber Guru (an Italian security awareness training platform) on a EUR23 million Series B round and assisting the Green Transition Fund (direct fund managed by CDP Venture Capital) with its EUR10 million seed investment round in Arsenale Bioyards. Recently, the VC team also assisted Limolane in expanding its business, including acquiring Asia Car Service and Service Vill. The team also supported Limolane in selling a minority stake to Cherry Bay Capital Group, in a EUR35 million financing round. Lastly, it assisted Azimut with a EUR40 million investment in Alps Blockchain Spa, a leader in blockchain R&D and mining.

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Italy's Venture Capital Renaissance: A 2025 Perspective

In recent years, Italy's VC ecosystem has emerged as one of the most dynamic and fast-evolving landscapes in Europe. Historically underdeveloped compared to other major EU economies, Italy has witnessed an impressive transformation marked by rising deal volumes, a proliferation of VC players, and strategic public-private initiatives. As of 2024, Italian start-ups raised EUR1.1 billion through 628 deals, contributing to a cumulative EUR8.6 billion invested over the last decade – a 467% increase since 2015. With over 300 active VC players today, up from fewer than 30 ten years ago, Italy is no longer on the periphery of European innovation but is increasingly recognised as a fertile ground for entrepreneurship and high-growth ventures. This upward trajectory signals not only quantitative growth but a qualitative evolution in how Italy conceives, supports and scales innovation-driven enterprises. The country's venture scene is no longer characterised by isolated initiatives or experimental pilot programmes but by a growing maturity in financial instruments, stakeholder coordination and global connectivity. A confluence of structural reforms, generational shifts in attitudes toward entrepreneurship, and increasing international exposure has led to the solidification of VC as a critical pillar of economic policy.

Italy's ascent in the European VC rankings is emblematic of a broader cultural and economic shift. Once trailing behind countries like Austria and Portugal, Italy has now surpassed them, becoming a noteworthy player in the continental innovation arena. The maturation of Italy's start-up ecosystem can be attributed to multiple converging factors: greater availability of capital, improved regulatory frameworks, enhanced collaboration between universities and industries, and a new generation of entrepreneurs with global aspirations. These entrepreneurs are increasingly multilingual, internationally educated, and unafraid to iterate quickly or pivot when needed – qualities that mark a distinct break from earlier, more risk-averse business practices. Furthermore, the growing availability of entrepreneurial education, incubation programmes and structured mentorship has helped narrow the knowledge gap that previously hampered early-stage innovation efforts. Today, Italy not only produces more start-ups, but better-prepared ones, capable of navigating complex market dynamics and investor expectations from day one. Simultaneously, a vibrant community of angel investors, sector-specific accelerators and corporate venture arms has emerged to complement traditional VC players, offering a broader spectrum of funding and strategic guidance.

The increase in venture activity reflects this transformation. Between 2020 and 2024, Italy recorded sustained growth in both early-stage and growth-stage investments. Seed funding has become more accessible, while Series A and B rounds are increasingly led by both domestic and international investors. This trend signals rising confidence in Italian start-ups' ability to scale and succeed globally. In the past, one of the most critical limitations facing Italian founders was the perceived lack of *"follow-on capital"* the ability to secure funding after the initial seed stage. That narrative is beginning to shift, thanks to the entry of new players with deeper pockets, syndication with foreign funds and greater investor willingness to support scale-up journeys over longer time horizons. These shifts are also fostering a more ambitious start-up mindset, where exit strategies, unit economics and global market penetration are considered from the outset, rather than as distant hypotheticals.

The Italian VC market has seen concentrated investment in technology-driven sectors, particularly AI, fintech and greentech. These areas are viewed as strategic not only for economic growth but also for aligning with broader societal goals such as digital transformation and sustainability. The emphasis on these sectors is also a reflection of broader European priorities and global market trends. Policymakers and investors alike understand that innovation in these domains carries both immediate and long-term value, making them prime candidates for focused capital deployment and institutional support.

AI has emerged as a focal point, especially following a landmark partnership in October 2024 between OpenAI and Italy's state lender Cassa Depositi e Prestiti (CDP). This collaboration aims to accelerate the adoption of AI technologies among Italian start-ups and to attract funding from US investors. The deal underscores Italy's ambition to become a hub for cutting-edge AI solutions, particularly in manufacturing, healthtech and cybersecurity. AI adoption is increasingly seen as a national priority, not only for its potential to revolutionise traditional industries but also for its implications for digital sovereignty and competitive advantage. As Italian start-ups develop AI solutions tailored to specific local and European market needs, they carve out defensible niches that could position them favourably in the global AI race. Moreover, this partnership has catalysed new networks between Italian research institutions and global AI leaders, facilitating talent exchange and joint projects that further reinforce Italy's growing reputation in the field.

Fintech continues to thrive, with new ventures reimagining banking, payment systems and financial inclusion. Italy's traditionally conservative financial sector has begun embracing disruptive technologies, backed by increasing VC interest. This sector is witnessing a cultural shift, as traditional institutions begin to see start-ups not merely as competitors but as potential collaborators or acquisition targets. Fintech start-ups have capitalised on consumer demand for convenience, transparency and digital-first services, offering tailored solutions that address long-standing inefficiencies in banking, insurance and asset management. As regulations catch up with innovation, particularly through sandbox initiatives and digital identity frameworks, the pace of fintech evolution in Italy is set to accelerate further.

Greentech, meanwhile, has benefited from EU-wide initiatives, particularly the European Green Deal. Between 2021 and 2023, venture capital funding for green technologies in the EU rose by 30%, with Italy securing a growing share of that capital. Italian start-ups are innovating in areas such as renewable energy, sustainable agriculture and circular economy solutions. The country's geographic and climatic diversity, coupled with its industrial capacity and agricultural expertise, gives Italian greentech ventures a unique platform to test and scale solutions. Additionally, consumer awareness and corporate ESG commitments are pushing demand for sustainable products and services, creating strong market pull alongside policy push. Investors recognise the dual benefit of impact and financial return in this space, making greentech one of the most promising areas for long-term capital deployment in Italy.

At the heart of Italy's venture capital growth lies CDP Venture Capital, the venture arm of CDP. Established to bridge the funding gap in the Italian innovation ecosystem, CDP Venture Capital has launched a diverse portfolio of funds sup-

porting start-ups from ideation through international expansion. Its mission is twofold: to catalyse private investment and to support strategic national interests through innovation. By acting as both investor and ecosystem builder, CDP Venture Capital plays a dual role that is unique among European public players. Its presence often de-risks early-stage deals, providing validation and confidence that attracts co-investments from private actors who might otherwise remain on the sidelines.

CDP Venture Capital operates through both direct and indirect investment strategies. Its direct funds focus on sector-specific initiatives, while indirect funds (funds of funds) invest in independent VC managers to scale impact. The scope and structure of these funds reflect Italy's commitment to becoming a serious contender in global innovation. The design of these instruments reflects a clear understanding of market gaps and leverages targeted interventions to stimulate systemic change.

CDP Venture Capital's direct funds include the Artificial Intelligence Fund, which targets start-ups engaged in AI, cybersecurity and quantum technologies, especially those with applications in strategic industrial sectors for Italy. Green Transition Fund backs start-ups and innovative SMEs driving ecological transition and developing green technologies. The Accelerators Fund builds a network of vertical accelerators in partnership with corporates, SMEs and international players, financing start-ups during and after acceleration. The Technology Transfer Fund focuses on commercialising scientific and technological research, working closely with universities and research centres to create deep tech start-ups. These vehicles are not just sources of funding but active participants in company-building, often providing access to technical expertise, strategic partnerships and policy advocacy.

The indirect funds or funds of funds include FoF VenturItaly II, a continuation of the original FoF VenturItaly, which supports funds managed by Italian general partners (GPs) and promotes international scaling of portfolio companies, and the International FoF, which invests in global VC funds to attract international capital and expertise to the Italian ecosystem. Through these vehicles, CDP Venture Capital fosters the cross-pollination of knowledge and capital, enabling Italian VCs and start-ups to integrate more seamlessly into global innovation networks. Such exposure accelerates learning curves, promotes best practices and opens up exit opportunities in larger markets.

Beyond national efforts, European institutions play a crucial role in reinforcing Italy's VC ambitions. The European Investment Bank (EIB), for instance, has increasingly focused on innovation financing. In October 2024, the EIB announced the European Tech Champions Initiative to provide late-stage capital to European scale-ups, including potential unicorns from Italy. This type of initiative is critical in addressing one of Europe's most persistent innovation gaps: the scarcity of late-stage growth capital, which often forces promising companies to relocate or sell prematurely. By anchoring such resources within Europe, and by extension in Italy, the EIB is laying the groundwork for a new generation of homegrown tech champions.

This initiative complements other EU programmes like Horizon Europe and the InvestEU Fund, which provide blended finance solutions for high-risk, high-potential ventures. Such support not only mitigates investor risk but also signals policy alignment at the continental level.

These mechanisms are particularly valuable in fields like deep tech, where long R&D cycles and capital intensity have traditionally limited private-sector interest. Blended finance also allows Italian start-ups to secure non-dilutive resources, improving their runway and enabling more ambitious experimentation.

The synergy between national and European programmes creates a robust pipeline of capital and resources, helping Italian start-ups navigate the so-called *"valley of death"* and scale beyond domestic markets. Access to multiple layers of financial support, coupled with cross-border visibility and mentorship, enhances survivability and growth potential. Moreover, EU support provides a degree of policy consistency that reduces uncertainty for investors and founders alike, making long-term planning more feasible.

Despite its progress, Italy's VC ecosystem faces several challenges: regional disparities and a lack of co-ordination among innovation hubs can limit national cohesion. Many promising initiatives remain confined to metropolitan areas such as Milan, Rome and Turin, while southern regions and smaller cities struggle to attract comparable attention and resources. Addressing these imbalances is essential for unlocking untapped potential and ensuring inclusive growth. Talent retention remains another critical issue. Many skilled professionals still seek opportunities abroad due to better compensation and more mature start-up environments. Reversing this trend will require not only competitive salaries but also robust career pathways, professional development infrastructure and quality of life improvements that make Italy a viable long-term base for global talent. A relatively underdeveloped IPO market and limited M&A activity also constrain investor returns, curbing the full maturation of the capital cycle. While some progress is being made, further regulatory streamlining and a cultural shift toward celebrating entrepreneurial exits will be necessary to create a thriving exit environment.

However, these challenges are being actively addressed through policy reforms, international partnerships and cultural shifts. The increasing involvement of universities, corporate innovation labs and diaspora networks suggests a positive trajectory. New policies aimed at incentivising employee stock ownership, reducing bureaucratic burdens and improving digital infrastructure are creating more fertile ground for venture-backed growth. Diaspora engagement programmes, in particular, are bringing back know-how and capital from successful Italian professionals abroad, helping bridge the gap between global best practices and local execution.

Moreover, Italy has unique opportunities:

- a strong industrial base ideal for B2B start-ups;
- a rich design and manufacturing heritage conducive to hardware and robotics ventures; and
- growing interest from global investors, especially in deep tech and greentech sectors.

These structural advantages provide a differentiated value proposition in the European and global innovation landscape. Italy's capacity to integrate beauty, functionality and technical precision – rooted in its artisanal and engineering traditions – can become a cornerstone of its innovation identity. As venture capital increasingly looks for substance over hype, Italy's combination of depth, creativity and pragmatism may prove to be a winning formula.

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Italy's venture capital ecosystem is undergoing a profound renaissance. From a position of relative obscurity, it has rapidly gained prominence thanks to visionary institutional actors, a new wave of entrepreneurs, and favourable European dynamics. With more capital flowing into key sectors like AI and sustainability, Italy is poised to become a powerhouse of innovation in Southern Europe. Yet the journey is far from over. To sustain this momentum, ongoing efforts must focus on building scale, encouraging cross-border collaboration and nurturing talent. Structural reforms must continue with urgency, ensuring that legal, tax and administrative frameworks keep pace with the needs of a modern innovation economy. Education systems must evolve to equip the next generation with not just technical skills, but also entrepreneurial mindset and resilience. If successful, Italy will not only transform its economy but also contribute meaningfully to Europe's technological sovereignty and global competitiveness. The next decade holds the potential for Italy to become a net exporter of innovation and capital, reversing long-standing trends and asserting a new leadership role within the European venture space.

As we look toward 2025 and beyond, the Italian VC story is one of ambition, resilience and reinvention – a narrative that mirrors the entrepreneurial spirit driving its next generation of innovators. It is a story still being written, but one that already offers valuable lessons for countries seeking to ignite their own venture revolutions. By leveraging its unique strengths and addressing its remaining gaps, Italy stands on the cusp of redefining its economic future and contributing significantly to shaping the next chapter of European innovation.

JAPAN

Law and Practice

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southgate is a boutique cross-border transactional firm based in Tokyo, Japan. Founded in 2016 as a true partnership of Japanese and foreign lawyers, the firm's practice focuses on cross-border mergers and acquisitions, joint ventures, corporate governance and venture capital financings. southgate blends the experience and standards of a large international law firm with the responsiveness, flexibility, accessibility and personal attentiveness of a boutique. The firm's team of Japanese and US lawyers combines strong Japanese law capabilities with an international approach and a deep understanding of overseas business practices to deliver the level of service global clients expect for their most challenging cross-border matters. southgate and its attorneys are recognised by Chambers & Parters for their expertise in M&A.

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1. Trends

1.1 VC Market

In 2024, Japan's start-up ecosystem witnessed relatively robust VC activity, with several groundbreaking transactions that showcased the growing maturity and global appeal of the country's entrepreneurial landscape.

The most notable VC financing during this period was Sakana AI's JPY30.1 billion Series C round, led by New Enterprise Associates (NEA), Khosla Ventures, and Lux Capital. In this round, Sakana AI achieved unicorn status, doing so faster than any other Japanese company before it. The participation of foreign investors in the financing round also underlines the increasing interest of international investors in Japanese start-ups.

In addition, the Japanese government has decided to invest JPY100 billion in Rapidus, a company that aims to produce next-generation semiconductors within Japan, by the end of 2025. The purpose of this investment is thought to be twofold: to clarify the government's stance on strengthening support for the domestic semiconductor industry and to attract the necessary private-sector investment and loans for mass production of Rapidus's products as quickly as possible. Private companies such as Toyota Motor and NTT are also planning to invest a total of approximately JPY100 billion, bringing the total expected investment amount to around JPY200 billion.

The Japanese IPO market also saw several high-profile debuts in 2024. Timee, an on-demand job introduction and matching platform, went public with an initial market capitalisation of JPY176 billion. Astroscale Holdings, a space sustainability compan focused on removing space debris, also completed a successful IPO with an initial market cap of JPY144.8 billion.

There was considerable activity in the M&A space as well, with major acquisitions such as that of fundbook, an investment management SaaS platform, and Cancerscan, a preventive healthcare service for municipalities.

These sizable transactions are indicative of the increasing scale and sophistication of Japanese start-ups at a time of growing interest from global investors.

1.2 Key Trends

Although the Japanese VC market is relatively small considering the size of Japan's economy, the market is growing and there is generally a feeling of optimism among market participants. While there is an increasing number of Japanese start-ups facing down or flat rounds, the downturn has been more moderate than in other key global VC markets such as the United States.

The challenges facing the Chinese economy, combined with a significant number of global investors opting to retreat from China, have benefited Japan as the recipient of a substantial share of the funds that had previously been pouring into China. Some well-known overseas VC funds entered the Japanese market in 2024, and Andreesen Horowitz also announced its plans to open a Japan office, bolstering the image of Japan as a stable and low-risk haven in an otherwise volatile region.

Despite these positive trends, unicorns (private companies with a USD1 billion-plus valuation) remain rare in Japan. Among the 1,250 unicorns that existed worldwide at the end of 2024, only eight were based in Japan, according to CB Insights' State of Venture 2024 Report.

Due to the increase in interest from global investors and the growing maturity of the ecosystem for start-ups in Japan, many observers expect the Japanese VC market to continue developing at a steady clip. Government-backed funds have also entered the VC market in recent years, demonstrating a growing awareness and emphasis on the need to support and develop the country's VC market.

In contrast to countries with VC markets that are perceived to be founder-friendly (eg, the United States and Israel), Japan has a reputation for being an investor-friendly market.

In terms of financing methods, for start-ups in Japan at the earliest stages, 2024 saw continued popularity of the J-KISS convertible equity instrument for seed round financings (additional detail on the J-KISS is provided in **3.3 Investment Structure**). There has also been a notable growth trend in venture debt financings, including loans with stock acquisition rights and convertible bonds, as alternatives to traditional equity fundraising.

1.3 Key Industries

According to the 2024 Japan Start-up Finance report by Speeda, the SaaS and generative AI sectors led in both total funding raised and number of companies securing investments, followed by the IoT and healthcare sectors. Smart HR, a prominent HR tech company, raised over JPY20 billion in its Series E round, while Sakana AI, a generative AI start-up, raised JPY30.1 billion, the most funding raised by a Japanese start-up in 2024.

Comparing median funding amounts by sector in 2024, the autotech and space sectors stood out, with values more than 1.5 times that of the third-place SaaS sector, according to Speeda's 2024 report. Notable investments include TIER IV, which develops automated driving software, and ArkEdge Space, which develops nano-satellites, both ranking among the top ten start-up funding rounds in Japan in 2024 in terms of total funds raised.

Despite a downward trend in total funding and number of companies raising capital since 2022, the average and median funding amounts per company have increased. This trend appears consistent across sectors, with no significant difference between industries in terms of VC-backed exits or growth in funding rounds.

2. Venture Capital Funds

2.1 Fund Structure

VC funds are often organised as investment limited partnerships (commonly referred to as LPS or, in Japanese, t *oshi jigyo yugen sekinin kumiai*) in Japan or similar structures formed outside Japan due to their tax benefits and flexibility in allocating profit distribution. Ordinary limited liability partnerships (LLPs) are poorly suited as fund investment vehicles because an LLP's decision-making authority is generally allocated among all the partners in the partnership under Japanese law.

Except for certain legal forms, there are no restrictions on the qualifications of the general partner (GP) of an LPS. However, the GP bears unlimited liability for the LPS's liabilities, and in order to avoid the risk of this unlimited liability being imputed to the GP's owners and investors, it is common for the GP to be a corporation (*kabushiki kaisha*) or limited liability company (*godo kaisha*).

Similar to other jurisdictions, in Japan, a VC fund in the form of an LPS is formed by entering into a Limited Partnership Agreement for Investment (LPSA) among the GP, who is responsible for the management of the fund, and the limited partners (LP's), who provide the capital. The specific provisions regarding governance of an LPS, including the authority of the GP and the LPS's, as well as the management of the LPS's assets, are set forth in the LPSA. A model LPSA has been published by Japan's Ministry of Economy, Trade and Industry.

When a VC makes investment decisions, it is common for an investment committee composed of officers, employees and other members of the GP, to be convened. The decision to proceed with an investment is typically made based on the outcome of the committee's discussions.

2.2 Fund Economics

In Japan, Fund Principals participate in the economics of VC funds using similar means as in many other jurisdictions: primarily carried interest and management fees. With respect to carried interest, the GP receives a fixed percentage (for example, 20%) of the returns exceeding a certain threshold, often the amount of the fund's capital contributions. An important caveat to this is that some more traditional funds (especially the corporate VC funds, or CVCs, of large companies) provide little or no carried interest incentive to the personnel involved in the fund. In recent years, however, there have been some examples of Japanese CVCs introducing stronger incentive compensation systems.

Management fees, on the other hand, are provided to the GP as compensation for the GP's management of the fund's operations. These fees are usually a percentage (for example, 2%) of the total fund size and are paid to cover operational costs and compensation for the personnel involved on behalf of the GP. The fixed percentage that applies to a fund's carried interest or management fee may be adjusted if certain performance thresholds are reached (in the case of carried interest) or based on the stage of the fund (in the case of management fees).

The GP typically has various obligations under the LPSA in respect of managing the partnership's assets, including proper disclosure, restrictions on the management of other funds and self-dealing, and the implementation of governance measures specified in the LPSA. These obligations are intended to ensure appropriate management of conflicts of interest and improve the transparency and fairness of the fund's operations.

2.3 Fund Regulation

When VC funds are organised as LPSs, they are primarily subject to regulation under the Financial Instruments and Exchange Act and the Limited Partnership Act for Investment. As a general rule, these funds are required to register in connection with their fundraising from LPs and use of LP funds for investing activities. However, due to certain financial requirements and the considerable time needed for registration, it is common for funds to take advantage of exemptions from the registration obligation by limiting their fundraising to investors with a certain level of assets and sophistication. In addition, under the Limited Partnership Act for Investment, investments by LPSs in foreign entities are limited to less than 50% of the total capital contributions of all partners.

At the time of the initial execution of the LPSA, the fund must complete a commercial registration process with the local Legal Affairs Bureau

registering its formation, and the fund is required to update its commercial registration upon the occurrence of a change in its registered information thereafter.

2.4 Particularities

Corporate VC (CVC) activity is an important part of the VC ecosystem in Japan. CVC investors view investments in, commercial partnerships with, and acquisitions of start-ups as a means to enhance their R&D and other innovation activities. As in other markets, many CVCs view commercial synergies as key part of their investment strategy and place a lower emphasis on financial return than traditional VC funds.

Additionally, the Japanese government is active in its support for start-ups and VC funds. For example, the government provides financial support to start-ups through the Development Bank of Japan and makes LP investments in VC funds through the Japan Investment Corporation (JIC). As of the end of January 2025, the JIC had announced 49 investments in VC funds since 2020. In 2024, the JIC made nine investments in both domestic and international VC funds, with investment amounts ranging from approximately JPY1.5 billion to JPY4.5 billion. Additionally, certain recent tax reforms, which are discussed in **4.2 Tax Treatment**, have been established to incentivise VC investments.

3. Investments in Venture Capital Portfolio Companies

3.1 Due Diligence

In Japanese VC financings, full legal due diligence is typically conducted by the lead investor, and more limited legal due diligence is sometimes conducted by follow-on investors.

The key areas of focus in legal due diligence are usually capitalisation, intellectual property, compliance and labour, but other areas may also be covered depending on an investor's risk appetite as well as the nature and size of the transaction.

Most investors conduct detailed intellectual property due diligence given the significant problems that may arise when a start-up fails to comply with Japanese laws regarding employee inventions. Investors also tend to scrutinise compliance with labour and privacy laws because these are areas often overlooked by many start-ups, particularly in the early stages of the company. In some cases, such as where a start-up is in a novel industry, investors will examine the start-up's business to ensure that it does not run afoul of any regulations covering such business.

Until recently, it was uncommon for Japanese VC investors to perform due diligence in the areas of anti-money laundering or anti-bribery and corruption compliance, export restrictions, and sanctions compliance, but the entry of large overseas institutional investors into the Japanese market has been leading an increasing number of investors to examine these issues as well.

Since start-ups typically do not pay the legal fees of the lead investor in a round, the lead investor is not considered to be conducting due diligence for the benefit of all investors. Accordingly, there are cases where multiple investors in a round conduct their own independent due diligence.

In addition to legal due diligence, investors typically conduct financial due diligence and occasionally business due diligence too, though usually only in larger rounds.

3.2 Process

The typical process for a new financing round, from the term sheet through the consummation of the investment, takes two to three months, assuming that no Foreign Exchange and Foreign Trade Act (FEFTA) filing is required (more detail on FEFTA filings is provided in **7.2 Restrictions**). There are, however, cases where transactions are completed in only one month while other cases may take more than a year to complete.

If a FEFTA filing is required, the transaction will close only after receiving approval from the regulators. Preparing the FEFTA filing normally takes one to two weeks, and after the filing is submitted, it will typically take another two to four weeks to receive approval from the regulators. Regulators have recently started asking an increasing number of questions in the process of approving transactions, and parties are thus encouraged to submit the filing as soon as practically feasible.

As in many other jurisdictions, financing rounds in Japan typically require amending the start-up's shareholders' agreement (SHA), which in principle requires the consent of all shareholders that are party to the SHA. However, in cases where the SHA provides that it can be amended by a shareholder majority (or the majority holders of each class of shares), then approval from the applicable majority is sufficient in lieu of the approval of all shareholders. Separately, an issuance of new equity by a non-listed company generally requires the consent of the holders of two thirds of a company's capital stock under Japanese law, so it is ultimately necessary for start-ups to get supermajority shareholder approval for each financing. For start-ups that have already raised capital via the issuance of preferred stock, it is common practice for new financings to require the consent of a majority (or higher threshold) of the holders of the company's outstanding preferred stock, typically voting together as a single class.

In small-scale Japanese start-up financings, legal counsel typically advises the client directly, with limited or no direct contact between legal counsel for opposing parties. Accordingly, in these cases, legal counsel's role in conducting due diligence and negotiating the terms of the transaction documents is significantly smaller than in the US market and other jurisdictions where legal counsel plays a more active role. However, in larger financings, it is more common for the legal counsel for the start-up and the lead investor to play a more active role and to communicate and negotiate directly with each other.

3.3 Investment Structure

Investors in the first round of outside investment often purchase common stock or *"J-KISS,"* SAFE-like convertible equity instrument based on the Keep It Simple Security (KISS) developed by 500 Startups in the United States and subsequently adapted to the Japanese market. The economic features of the J-KISS are similar to those of the current post-money SAFE, except that the standard J-KISS is more favourable to investors because it includes both a discount and a valuation cap as well as a most favoured nation provision. In comparison to the SAFE, the J-KISS is significantly more complex and time-consuming to implement.

In subsequent rounds of outside investment, investors usually receive preferred stock. Some of the rights received by preferred stockholders typically include: liquidation preferences, anti-dilution adjustments, reserved matters and veto rights, pre-emptive rights for new share issuances, rights of first refusal and co-sale or

tag-along rights, drag-along rights, board and observer rights, and information rights.

3.4 Documentation

In convertible equity (J-KISS) financings, the key deal documents are the term sheet (though a term sheet is not used in all J-KISS financings) and the J-KISS, which is itself comprised of an investment agreement and *"terms of issuance"* document that sets forth the key terms and mechanics of the instrument.

In equity financings, the key deal documents are the term sheet, the investment or subscription agreement, the shareholders' agreement, and the articles of incorporation. While the investor almost always prepares the term sheet, the start-up generally prepares the remaining documents. Parties sometimes choose to also enter into side letters.

In some cases, the shareholders' agreement is split into two separate agreements: a distribution agreement for deemed liquidations (in contrast to *"true liquidations"* addressed in the articles of incorporation), and a shareholders' agreement without the deemed liquidation provision.

The same investment or subscription agreement is typically signed by all investors, but there are also cases where different investors request customised provisions and thus sign slightly different investment agreements.

Most practitioners use a publicly available form of the J-KISS. While there are publicly available templates for the other deal documents as well, they are not used as widely as the standard form of J-KISS. Thus, documents used in Japanese VC financings are generally more varied than their equivalents in other markets with well-established standard forms such as the United States.

Companies with many foreign investors sometimes opt to use English-language financing documents, but it is much more common for the documents to be prepared in Japanese, in which case foreign investors will need to rely on English translations that are prepared for reference purposes only. Even in the rare cases where English-language documents are used, Japanese will typically be the controlling language of certain provisions in the investment agreement that are required to be reflected in the start-up's certificate of incorporation or commercial registration (eg, the rights and preferences of the preferred stock).

3.5 Investor Safeguards

Outside of the first financing rounds, when a J-KISS may be used, VC investors generally invest through preferred shares and receive a liquidation preference, which is often participating and uncapped. These liquidation preferences apply not only to *"true liquidations"* but also to M&A exits and other deemed liquidations, and therefore will benefit preferred stockholders in the event of portfolio company sales and liquidations.

Additionally, weighted average anti-dilution protections (broad-based or narrow-based) are typically granted to preferred stockholders. It is quite rare to see full-ratchet anti-dilution protections.

3.6 Corporate Governance

Each class of preferred shares is typically entitled to one seat on the start-up's board, though this partly depends on the shareholding percentage of the class following the closing. A class that makes up a significant percentage of all outstanding shares may receive multiple board seats, whereas a class with a low percentage may not receive any board seats at all.

The general market practice is that, if a class of preferred shares is entitled to a board seat, the lead investor in the class will have the right to designate the class director.

Observer rights are sometimes given to large investors that are not eligible for a board seat.

Under the Companies Act, if a company creates a new class of shares or takes certain other actions that will adversely affect the rights of existing shareholders, the company must obtain the consent of the holders of two thirds of each class of the company's shares (including common shares) before such actions are considered effective. In addition to statutory consent rights, preferred stockholders are typically given contractual consent rights with respect to other material matters. The approval of reserved matters usually requires the consent of a specified percentage, such as a majority, of holders of all classes of preferred shares, voting together.

3.7 Contractual Protection

In a financing round, the principal contracts include representations and warranties with respect to matters that are commonly covered in many other jurisdictions, including the valid existence of the start-up, its capitalisation, compliance with law, the accuracy of financial statements, the absence of litigation and bankruptcy proceedings, and certain employment matters, among other items. One additional item covered by the representations and warranties that may be unique to Japan is the absence of relationships with *"anti-social forces." "Anti-social forces"* is a designation under Japanese law for organised crime groups and similar persons that engage in behaviour harmful to society, as well as persons providing support to these groups. It is customary in Japan for commercial and corporate transaction agreements to include representations and warranties as to no relationships with anti-social forces and to allow immediate termination of the agreement if such a relationship arises.

The contracts in Japanese VC financings also typically include rights and covenants that are common in other jurisdictions, such as a right of first refusal, tag-along rights, drag-along rights, and certain veto rights for preferred stockholders. It is also common for the founders to agree to remain in their management roles at the start-up, to enter into non-compete obligations in the transaction documentation, and to agree not to dispose of any shares of the start-up. In addition, it is fairly common for founders and the start-up to agree to exercise reasonable commercial endeavours to complete a public listing of the start-up's stock within a specified number of years (often around six to eight years from the first outside investment round). If the founders or the start-up fail to exercise such efforts, they have an obligation to repurchase the investors' shares, but these repurchase provisions are very rarely enforced.

A breach of warranties or covenants can lead to disputes, with potential breaches of veto rights on material corporate matters being a particular area of focus for investors.

In Japan, it is rare to see formal legal claims arising from disputes in VC financings because the potential damages that can be recovered (which are usually quite low compared to other jurisdictions such as the United States) in most cases will not justify the cost of bringing the claim. Investors also may conclude that it is not in their best interest to bring suit against the start-up or its management team, because the investors themselves are shareholders of the start-up and the start-up's success depends heavily on the

performance of the individuals who would be the targets of the suit.

In many cases, investment agreements or shareholders' agreements grant investors a right to have their shares in the start-up repurchased by the start-up and/or the founders if the agreements are materially breached. Despite having this strong remedy, investors rarely exercise their put options because they are viewed as a drastic remedy that could cause the exercising investors to suffer reputational consequences.

Disputes are usually resolved amicably and the particular facts that gave rise to the dispute will determine the specific resolution. For instance, a company that breaches a post-closing covenant may agree, in a side letter, to implement remedial measures designed to prevent the recurrence of the breach. In a case where a breach of a representation and warranty that has the effect of diminishing the company's value is found post-closing, one resolution may be for investors to receive commensurate compensation in the form of warrants, though this outcome is uncommon.

4. Government Inducements

4.1 Subsidy Programmes

In 2022, the Japanese government announced that it was designating that year as the *"first year of start-up creation"* and announced *"Five-Year Start-up Development Plan"* (the *"Plan"*) The Plan aims to increase investment in start-ups from approximately JPY800 billion in 2022 to JPY10 trillion by 2027, more than a tenfold expansion. It is structured around the following three pillars:

- building talent and networks for start-up creation;
- strengthening funding for start-ups and diversifying exit strategies; and
- promoting open innovation.

As part of the Plan, several years ago the Japanese government established a tax incentive for individuals to invest in early-stage start-ups. The national government has also made some revisions to immigration procedures to make it easier for foreign founders to use in a bid to attract more overseas entrepreneurs.

4.2 Tax Treatment

As a general matter, start-up investments by individuals typically qualify for taxation at the capital gains rate (approximately 20%), which is generally lower than the tax rates applied to ordinary income.

The Japanese government has also introduced some special incentives through tax reforms implemented under the Plan. The *"open innovation tax incentive"* currently provides that when Japanese companies or CVCs acquire shares in start-ups in Japan or overseas, they can deduct 25% of the acquisition cost from their taxable income. This is a temporary measure set to expire at the end of 2025, but there is a possibility that it may be extended through future legislation. Individual investors may qualify for the so-called *"angel"* tax incentive, meant to incentivise angel investment. This tax incentive applies when an individual invests in a start-up that meets certain requirements, including being in business for less than five years. At the time of the investment, the investor may deduct the amount of the investment from their annual taxable income or capital gains from the sale of stock, resulting in a tax reduction. Furthermore, if the investor recognises a capital loss instead of a capital gain when disposing of the invest-

ment, the investor can offset it against capital gains from the previous three years.

4.3 Government Endorsement

The Plan (see **4.1 Subsidy Programmes**) is a policy initiative aimed at boosting start-up investment in Japan, with the Japanese government taking the lead in promoting such investments. As part of this initiative, the government seeks to stimulate private investment by actively encouraging government agencies to invest in VC funds, both domestic and international, that focus on start-up investments, as well as by promoting direct investments in start-ups through public-private funds.

5. Employment Incentives

5.1 General

It is common to provide incentives that allow founders and employees to benefit from the long-term growth of the company through stock options or stock ownership. This includes setting a vesting period for stock options and stock grants. In addition, although it is not typical for founders' initial equity ownership to be subject to vesting, it is fairly common for the founders' agreement to provide the remaining founders a right to purchase all of a departing founder's equity at a nominal price (or, alternatively, fair market value at the time of departure) if the departing founder leaves the company before an exit has been completed.

It is also common for the founders to agree in the investment documentation to continue their current roles at the start-up following the investment, most typically for an indefinite period. Under Japanese law, such agreements are generally considered valid with respect to founders (who are serving as directors of the start-up) but are considered invalid if applied to employees unless limited to a certain permissible period of time under Japanese employment law.

5.2 Securities

Stock options and stock grants are the principal instruments with which founders and employees are typically incentivised. Start-ups typically allocate about 10-15% of their outstanding shares for stock options.

For the tax-qualified stock options referred to in **5.3 Taxation of Instruments**, the exercise period must be between two years and up to 15 years after the grant date (depending on the period of the start-up's existence), and the exercise amount must not exceed JPY36 million per year (again, depending on the period of the start-up's existence). In addition, it is common for the exercise conditions to require that the founders or employees to whom the options are granted are still providing services to the start-up at the time of exercise. As mentioned in **5.1 General**, stock held by founders is sometimes subject to purchase by other founders at a nominal price (or, alternatively, fair market value at the time of departure) in the case of the stockholder's departure from the start-up.

5.3 Taxation of Instruments

In Japan, there are two types of stock options: tax-qualified (the capital gains rate applies and taxation is deferred until the shares underlying the option are disposed) and non-tax qualified (the ordinary income tax rate applies and the exercise of the stock options constitutes a taxable event). Until recently, tax-qualified stock options had been impractical and were ill-suited for start-ups seeking M&A exits rather than IPO exits, but certain administrative and legislative actions taken in 2023 and 2024 have made stock

options a much more accessible tool for start-ups.

5.4 Implementation

In VC financings in Japan, the valuation of the company is typically negotiated such that the dilution from a new or expanded option pool is shared among the existing stockholders as well as the new investors. This contrasts with the USA, where the new investors typically do not bear the burden of any dilution from the option pool.

This difference may be due to the Japanese legal system. In Japan, until recently stock options could only be issued within one year following the board resolution approving their issuance, so it was not possible to create an option pool in the same manner as is commonly done in the USA. However, with the changes to the law in 2024, it will now be possible to establish an option pool in Japan, albeit subject to certain procedures. This development could lead to the establishment of market practices more closely aligned with those of the USA, such as a refreshed option pool for each financing round and the adoption of a pre-money valuation approach to VC investments.

6. Exits

6.1 Investor Exit Rights

Preferred stockholders have priority over common stockholders in the case of both actual liquidations and deemed liquidations, such as M&A exits. While pari passu liquidation preference among classes of preferred shares is not uncommon, it is more common for subsequent classes of preferred shares to have priority over earlier classes. In most cases, preferred stockholders' liquidation preferences are uncapped and participating, meaning that, after receiving their preference, each of the preferred stockholders receives its pro rata share of the liquidation proceeds available to common stockholders as if its shares had converted to common stock.

Japan does not have an active secondary-share transfer market. Although there are no statutory restrictions on the resale of unlisted securities, it is almost always the case that transfers of shares in privately held companies require approval of the board of directors or the shareholders (if a company does not have a board of directors). In Japanese start-ups, rights of first refusal and co-sale provisions are common and, in most cases, bind all major shareholders, including both common and preferred holders.

For these reasons, investors in Japanese start-ups rarely sell their shares prior to an exit despite the lack of statutory restrictions on the sale of shares of private companies. Investors who wish to sell their shares typically do so in a sale to other investors as part of a subsequent financing.

6.2 IPO Exits

Japanese start-ups have traditionally favoured IPO exits due to the widespread perception that a start-up that exits through M&A has failed. Many founders and traditional VC investors aspire to a listing, and thus the number of IPO exits far outnumber M&A exits. However, M&A exits have been increasing in recent years as a result of pressure from investors (primarily those from overseas) who want to see a quick return on their investment, the slower IPO market in Japan, and the fact that many successful start-ups in other markets are exiting by M&A.

The typical successful IPO outcome for start-ups is to list their shares on the Growth Market of the Tokyo Stock Exchange while raising capital via an issuance of new shares.

6.3 Pre-IPO Liquidity

As noted in **6.1 Investor Exit Rights**, no active secondary-share transfer market exists in Japan. Founders (and other key common stockholders) and preferred stockholders typically benefit from and are subject to rights of first refusal and co-sale (or tag-along rights), which means that all such stockholders wishing to sell their shares must comply with the required procedures for the rights of first refusal and co-sale (or tag-along rights).

Key challenges for developing a secondary trading market in Japan include the lack of established legal and regulatory frameworks and the need for standardised transaction processes, as well as restrictions prohibiting securities brokerage firms from dealing with shares of private companies except in certain limited circumstances. Company-facilitated tender offers are not particularly common in Japan. As noted in **6.1 Investor Exit Rights**, it is common for start-up investors to aim for an IPO and traditionally there has not been a great demand for pre-IPO liquidity in typical cases.

7. Regulation

7.1 Securities Offerings

In Japan, start-ups' activities involving marketing and selling shares in pre-IPO financings are subject to various restrictions under the Financial Instruments and Exchange Act (FIEA), including prohibitions on general solicitation. Due to these restrictions under the FIEA, the investors in start-up financings are typically limited to qualified institutional investors, a limited number of non-qualified investors, and existing shareholders.

For start-ups with numerous small shareholders, securing required supermajority approval (two-thirds for new equity issuances) can be logistically challenging.

7.2 Restrictions

The FEFTA regulates investments made by foreign investors in Japanese companies engaged in business in industries that have been designated as important from the perspective of national security and public welfare, such as the software and ICT industries among others. In these designated businesses, even minority foreign investments require advance notification to, and approval from, the Japanese authority. The statutory review period for notifications is 30 days from the acceptance of the notification, but depending on the circumstances, this period can end up being as short as one to two weeks or as long as several months.

A foreign investor seeking to appoint a related person as a board director of a company that operates in a designated industry must file not only the advance FEFTA notification for the investment itself but also the advance FEFTA notification with respect to the proposal for the election of the director.

Even in cases where the company is not operating in a designated industry, foreign investors in Japanese companies (together with their related parties) whose ownership or voting rights exceed 10% must make informational filings with the Bank of Japan after the closing.

Revisions to ministerial ordinances in this area are being planned with two key changes: first, investors who are legally required to co-operate with foreign intelligence activities (particularly Chinese investors under China's National Intelligence Law) will be prohibited from using the prior notification exemption system; secondly, a new category of *"specified core business operators"* is to be established as a designated industry classification. Foreign investors who may be affected should monitor this issue carefully.

Trends and Developments

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TMI Associates is one of the five largest full-service law firms in Japan, with 630 attorneys and 100 patent attorneys boasting extensive domestic and international practical experience. With a focus on fostering global partnerships, TMI has successfully established joint ventures with several prominent international law firms. Moreover, TMI has been actively expanding its presence abroad, with bases strategically positioned across the Asian region, as well as its presence in the US, Europe, Africa and South America. Leveraging the expertise of TMI's intellectual property (IP) practice, its corporate/M&A team leads the market in IP-centric sectors, encompassing not only life sciences, pharmaceuticals, and IT, but also emerging fields such as fin-tech, health-IT and AI. Since the inauguration of its Silicon Valley office in 2014, TMI has an extensive track record in assisting both start-ups and investors and has become renowned as the leading Japanese law firm in the field of venture capital. TMI's venture capital and start-up practice group, comprising over 50 attorneys, exemplifies TMI's commitment to nurturing innovation and entrepreneurship.

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Introduction

In Japan, there has been a significant increase in attention towards start-ups in recent years. The Japanese government has been advocating various studies and policy proposals related to start-ups, including the publication of the *"Start-up Development Five-year Plan"* (the *"Plan"*) in 2022. According to a report from INITIAL, a Japanese start-up information platform, the amount of funds raised by Japanese start-ups has been increasing annually over the past decade, and in 2022, the funds raised reached a record high of nearly ten times the amount raised in 2013. Additionally, this report indicates that the funds raised by Japanese start-ups in 2024 amounted to approximately USD5.20 billion (2,869 cases), and once all funding amounts are known for the year,, the total amount raised is projected to be an approximate 3% increase compared to 2023.

Furthermore, according to the same report from INITIAL, investments by venture capital (VC) funds, including corporate venture capitals (VC arms of corporate entities) (CVC), accounted for 39.1% of the investment amounts in 2024. Considering that the investments by corporate entities accounted for 21.3% of the second largest investment providers during the same period, it is evident that VC funds play a significant role in funding Japanese start-ups.

The following sections will provide an overview of fundraising, venture financing and exits in Japan, including trends, key methods and contract terms, as well as noteworthy regulations.

Fundraising

Trends

In Japan, various players are actively raising funds in the VC sector, including independent VC firms, VC arms of financial institutions, CVCs, government and university-affiliated VC firms, as well as overseas VC firms. Particularly notable is the surge in the establishment of funds by corporate entities aiming to invest in start-up companies through such funded vehicles, seeking synergies with the existing businesses of such corporate entities. Regarding investment focus, there is a growing trend towards funds targeting investments in the AI, deep-tech, IT, bio, medical, healthcare and environmental sectors.

Legal forms of VC

VC funds established in Japan typically operate under investment limited partnerships (JLPSs) organised under the Investment Limited Partnership Act. This is largely due to the Ministry of Economy, Trade and Industry (METI)'s publication of model agreements for JLPSs, which are familiar to both general partners (GPs) and limited partners (LPs).

Key characteristics of JLPSs include:

- GP(s) managing the operations of a partnership, while LPs refrain from involvement in business operations;
- GP(s) bearing unlimited liability for partnership debts, with LPs liable only up to their capital commitment;
- a cap limiting the acquisition and holding of foreign corporate shares to less than 50% of the partnership's assets; and
- the adoption of a capital call method for capital contributions from partners in model agreements published by METI.

Regarding the limitation on the acquisition and holding of foreign corporate shares mentioned above, exemptions have been specified by METI for partnerships contributing to open innovation. Upon receiving certification from METI, these funds can acquire shares of foreign corporations beyond the 50% limit.

In 2024, the Investment Limited Partnership Act was amended, and certain types of foreign entities (eg, the foreign arm of a Japanese company) were allowed to be exempt from the 50% limit. Also, (i) membership interests in Godo Kaisha and (ii) crypto-assets, etc, were added to the assets that JLPSs can acquire and hold.

When overseas investors invest in JLPSs, there is a possibility of being taxed in Japan on the income distributed from such JLPSs, considering the overseas LPs having a permanent establishment (PE) in Japan. However, there are exceptions if certain requirements are met, while it is advisable for Foreign Investors (defined below) to consult with tax advisers when investing in JLPSs.

Overseas VC funds that raise funds from Japanese investors are often conducted through overseas limited partnerships. Limited partnerships formed in jurisdictions such as the Cayman Islands, California, Delaware, Luxembourg, Ireland and Singapore are frequently utilised.

Financial Instruments and Exchange Act (FIEA) Regulations on the formation of funds

Overview of registration requirements and certain exemptions under the FIEA

Interests in VC partnerships are considered as *"securities"* under Japan's FIEA, thus making the solicitation thereof subject to the provisions of the FIEA. Those conducting (a) solicitation to Japanese residents are generally required to register as Type II Financial Instruments Business Operators, and those engaging in (b) the management of contributed assets in securities are generally required to register as Investment Management Business Operators.

However, if the investors include at least one qualified institutional investor (QII), and the other investors (if any) are all certain sophisticated investors (Non-QIIs), and the number of Non-QIIs is fewer than 50, instead of the above registration, a notification for the *"Specially Permitted Businesses for Qualified Institutional Investors, etc."* (SPBQII Exemption) can be submitted to the Kanto Finance Bureau, allowing the conduct of activities (a) and/or (b).

Considering the complexity of procedures and the duration of processes, the hurdle for registering as a Financial Instruments Business Operator is quite high. Therefore, in cases where VC partnerships receive LP investments from Japanese residents, it is common for GPs to submit notifications for the SPBQII Exemption on the condition that the partnership meets certain requirements including the above-noted investor requirements. However, on occasion, overseas fund GPs are unaware of these regulations, leading to omissions in such notifications. Especially when the GP of an overseas fund receives LP investments from Japanese residents, it is advisable to consult with legal advisers in advance, including regarding the issue of whether QIIs are included among the investors.

A list of the GPs who have submitted notifications for the SPBQII Exemption and their funds is published on the Financial Services Agency (FSA) website.

Regarding the licence for (b) Investment Management Business Operators, there are specific exceptions for overseas funds.

Registration as an Investment Management Business Operator is not required in cases where:

- all of the Japanese investors (including indirectly invested investors) are QIIs;

- the number of Japanese investors is nine or fewer; and
- the total amount of money or other properties invested or contributed by investors does not exceed an amount equivalent to one third of the aggregate amount of money or other properties contributed from all of the LPs of the Limited Partnership fund, including offshore investors.

However, even in such cases, the need for a licence for the solicitation activities under (a) above remains. Therefore, it is necessary to either submit notifications for the SPBQII Exemption, or entrust the solicitation to a private placement agent holding a Type II Financial Instruments Business licence. Additionally, it should be noted that the regulations mentioned above apply to partnership-type funds, and different regulations apply to funds structured as trusts or corporations.

Post-notification obligations

After GPs submit a notification for the SPBQII Exemption, ongoing obligations include duties to:

- submit a notification if there are any changes to the items stated in the notification; and
- submit annual business reports.

Venture Financing

Trends

Japanese start-ups are adapting to global economic trends and technological advancements, driving changes in the landscape. While the total funding amount in 2024 increased compared to 2023, the market environment remains challenging for sectors oriented toward companies with high growth potential, such as the Tokyo Stock Exchange Growth Market. In this situation, the presence of VC investments has been increasing along with the growing importance of start-ups in Japan; however, as pointed out in the Plan, the volume of and amounts invested in VC investments in Japan remain relatively small compared to those overseas.

The Japanese government, with the assumption that VC funds have significant capabilities for evaluating start-ups plus the ability to nurture start-ups, has stated in the Plan that it will expand investment through limited liability investment of public capital into VC funds (including overseas VC funds) and will expand government support for start-ups in co-operation with VC funds.

This initiative includes strategic investments through the Organization for Small & Medium Enterprises and Regional Innovation, JAPAN (SME Support, JAPAN) and the Japan Investment Corporation (JIC) as follows.

JIC's investment initiatives

- In January 2023, JIC Venture Growth Investments (JIC VGI), a subsidiary of JIC, launched its second fund with a fund size of JPY200 billion. As of March 2024, it has executed 18 investments totalling JPY6.39 billion.
- To facilitate funding in the secondary market and for publicly listed start-ups, the JIC VGI Opportunity Fund No 1, with JPY40 billion, was established in September 2023, resulting in two investments amounting to JPY12 billion.
- JIC has committed a cumulative JPY174.9 billion to 41 private VC firms as of November 2024. It also invests in overseas VC firms to foster collaboration with domestic VC firms and start-ups.
- The fiscal year 2024 supplementary budget included JPY10.5 billion for industrial investment to support risk capital supply to regional university-based start-ups. Additionally, the

fiscal year 2025 Fiscal Investment and Loan Programme draft allocates JPY80 billion for industrial investment to enhance risk capital availability for start-ups.

SME Support, JAPAN's LP investments

- Since fiscal year 1998, SME Support, JAPAN has been providing LP investments to VC funds to stimulate the domestic risk capital market, promoting start-up formation and new business development among SMEs.
- Commitments of JPY319.7 billion have been made to 241 VC funds, leading to 308 portfolio companies achieving an Initial Public Offering (IPO(s)) on domestic emerging markets. More than ten of these IPO companies have exceeded a market capitalisation of JPY100 billion (as of March 2024).
- In fiscal year 2023, under the *"Global Startup Growth Investment Program"*, which allocated JPY20 billion from the fiscal year 2022 supplementary budget, two investments were made in global VC funds to support the international expansion of Japanese start-ups.
- In June 2024, the *"Young Capitalist Development Fund of Funds"* programme was launched to cultivate emerging VC talent, with applications now being accepted.

Surge in overseas investment and market entry in Japan's start-up ecosystem

Japan's start-up ecosystem is experiencing a notable surge in interest from overseas investors, driven by proactive government policy support. Below is a detailed overview of the investment and market entry trends.

Investment highlights

- October 2022: Caisse de dépôt et placement du Québec (CDPQ) invested in Shizen Energy.
- July 2024: KKR invested in SmartHR, and the Ontario Teachers' Pension Plan also made an investment.
- September 2024: Khosla Ventures and NEA invested in Sakana AI, while Bessemer Venture Partners and Hillhouse Capital invested in Dinii.

Market entry highlights

- December 2023: Techstars, a US-based venture capital-backed accelerator, established a presence in Japan.
- May 2024: Vertex Ventures expanded into the Japanese market.
- June 2024: Eurazeo, a leading French venture capital firm, entered Japan.
- September 2024: BLOCK71, a major Singapore-based accelerator, launched operations in Japan.

Investment trends

The data indicates a significant increase in overseas investment in Japanese start-ups during 2024, particularly in the technology sector. Investments from major pension funds highlight the strong confidence in the Japanese start-up market.

Market entry trends

The period from 2023 to 2024 has seen a series of international VC firms and accelerators establishing a presence in Japan, which is expected to foster stronger global partnerships and accelerate the international expansion of Japanese start-ups.

Contributing factors

Government policy support

Initiatives such as the Plan are creating a favourable investment environment, with streamlined visa requirements and attractive tax incentives.

Technological strength and market potential

Japan's advanced technological capabilities, especially in deep-tech, and its large domestic market are highly attractive to overseas investors.

Japanese yen exchange rate

The recent depreciation of the Japanese yen has made investments in Japan more cost-effective for Foreign Investors.

Overview of method of VC financing in Japan

Given that Japanese VC financing practices share many similarities with those in Silicon Valley, they are relatively easy for Foreign Investors to understand. However, the start-up environment in Japan has certain unique features that are attributable to Japanese laws and business practices.

For financing in a priced round, outside investors such as VC firms generally invest in Japanese start-ups in exchange for preferred shares, and the general flow of investment is as follows:

- signing of a non-disclosure agreement;
- negotiation and execution of a term sheet;
- conducting due diligence; and
- negotiation and execution of the definitive agreements.

The following items are generally included in the definitive agreements:

- proposed amendment to the Articles of Incorporation setting forth the features of the preferred shares;
- an investment agreement setting forth the terms and conditions for investment; and
- a shareholders' agreement.

Regulations under the Foreign Exchange and Foreign Trade Act (FEFTA)

Since investments in start-ups by Foreign Investors usually fall under the category of *"Foreign Direct Investment, etc."* (FDI), the regulations under the FEFTA must be examined prior to the investments.

The following points need to be considered:

- applicability to Foreign Investors;
- applicability to FDI;
- whether a target start-up falls within a Designated Business Sector; and
- availability of exemption for prior notification.

"Foreign Investors" are defined as:

- non-resident individuals;
- corporations or other entities established under foreign laws and regulations (Foreign Entities);
- Japanese entities where non-resident individuals or Foreign Entities directly or indirectly hold 50% or more of such entity's voting rights;
- general partnerships engaging in investment business and JLPSs (including partnerships under foreign laws) if:
  - (a) the ratio of capital contribution from non-resident individuals and others is 50% or more of the total amount of the capital contribution of the partnership; or
  - (b) non-resident individuals and others constitute a majority of the managing part-

ners of the partnership; or
- Japanese entities in which the majority of the directors/officers or directors/officers with representative authority are non-resident individuals.

In addition, the acquisition of even a single share of an unlisted company, such as a start-up, by a Foreign Investor falls under the FDI. Therefore, a foreign VC fund (or its partner) needs to consider whether to submit a prior notification or post-investment report upon the consummation of the FDI, unless certain exemptions apply.

To determine whether or not a prior notification is required, investors must confirm whether or not a target start-up engages in business in a Designated Business Sector. The scope of Designated Business Sectors has gradually been expanded over the past few years.

If an investment is subject to prior notification, then prior notification must be filed unless an application for exemption can be utilised. The transaction is generally prohibited for 30 days (which can be reduced to a minimum of two weeks) from the date of filing the prior notification. Even if prior notification is not required, a post-investment report may be required in certain cases.

The exemption is available if (i) the target start-up does not operate in Core Sectors, (ii) the Foreign Investor complies with the following three conditions, and (iii) the Foreign Investor is not disqualified from using the exemption because of, among other things, having previously been sanctioned for a FEFTA violation and is not a foreign government-owned company. Core Sectors mean specific industries among the Designated Business Sectors, as having a significant impact on Japan's National Security, etc.

The above-mentioned three conditions are as follows:

- investors or their closely related persons will not become board members or corporate auditors of the start-up;
- investors will not propose to the general shareholders' meeting of the start-up a transfer or other disposition and abolishment of its business activities in the Designated Business Sectors; and
- investors will not access non-public information about the start-up's technology in relation to its business activities in the Designated Business Sectors.

If the exemption is applied, a Foreign Investor is always required to file a post-investment report.

Financing documents for issuance of preferred shares

Articles of Incorporation

Under Japan's Companies Act, the Articles of Incorporation (AoI) set forth the basic rules of a corporation, and before the issuance of preferred shares, the features of preferred shares shall be set forth in the AoI. Some features of preferred shares in Japan are as follows.

Liquidation preference

- In the event of the dissolution or liquidation of a start-up, it is common practice to provide for the distribution of residual assets to preferred shareholders in preference to ordinary shareholders.
- It is also common to grant preferred shareholders the right to receive a second distribution together with ordinary shareholders on a converted basis (right of participation), if there are residual assets after the preferred dis-

tribution is made (usually one times (1X) the amount paid in).
- In addition, it is common to provide for *"deemed liquidation preference"*, which states that, in the event of an M&A transaction, the consideration therefor will be distributed preferentially to the preferred shareholders. This provision is usually also stipulated in the shareholders' agreement (or agreement on the distribution of assets).

Conversion – anti-dilution adjustment

- It is common practice to provide that preferred shareholders may request a start-up to convert their preferred shares into ordinary shares at a 1:1 ratio at any time. In Japan, this right is mainly used in the process of converting all preferred shares into ordinary shares prior to an IPO, since preferred shares cannot, in principle, be listed.
- In order to prevent dilution, a mechanism for adjusting the conversion ratio is often included, which is triggered by the issuance of shares at a price lower than the original purchase price (down round financing). It is common to use a narrow-based or broad-based weighted average method for adjustment.

Voting rights

- It is common to provide that preferred shares have the same voting rights as ordinary shares, specifically, one voting right per share.

Investment agreement

An investment agreement is an agreement between a start-up and investor(s) that mainly stipulates the economic terms of the investment, investment preconditions, covenants and representations and warranties (R&Ws). Investment agreements often provide not only indemnification obligations but also put options on the shares held by the investor(s), triggered by a breach of covenants or R&Ws, and stipulate that the founder(s) are jointly and severally liable for the purchase obligation of the start-up.

Shareholders' agreement

Shareholders' agreements are made by and between investors, start-ups and founders, mainly for the purpose of agreeing on matters related to:

- the management of the start-up;
- investor's rights such as the right to appoint directors and corporate auditors and the pro rata right/pre-emptive right;
- veto rights;
- the right to request the company's information; and
- rules for the disposal of shares such as the right of first refusal, the co-sale right/tag-along right, and the drag-along right.

The shareholders' agreement (in some cases the agreement on distribution of assets separate from the shareholders' agreement) will include a deemed liquidation provision, which is very important in the context of an exit through M&A. If this provision exists and an M&A transaction such as a merger or a transfer of shares with a change in control occurs, the consideration for the M&A transaction will be distributed to shareholders through the mutatis mutandis application of the liquidation preference provisions in the AoI, as if the start-up were being liquidated.

Convertible securities – J-KISS and CB

Early-stage start-ups are increasingly raising funds from investors by issuing *"J-KISS Stock*

Acquisition Rights" (J-KISS), a convertible equity instrument which is open to the public, as bridge financing. J-KISS is created based on the *"KISS"* (Keep It Simple Security) methodology, which was proposed and published by the US accelerator 500 Startups. At the time of acquiring J-KISS, the number of shares to be issued upon conversion by the future exercise thereof is undetermined. While this may seem unfavourable to investors, it also includes investor protections such as *"discounts"* and *"valuation caps"*, which are mechanisms that lower the price per share required to acquire a share or prevent that price from being higher by determining the share price based on an assumed valuation.

Since the acquisition of J-KISS does not fall under the category of FDI, prior notification is not required, regardless of whether the start-up is engaging in business in a Designated Business Sector, and J-KISS may be used by Foreign Investors as a means to make quick investments in Japanese start-ups. However, it should be noted that if J-KISS are exercised and converted into shares, this would constitute FDI.

Similar to J-KISS, convertible bonds with stock acquisition rights (CBs) are sometimes used. CBs differ from J-KISS (which have equity characteristics), in that they are debt instruments, but they share the same mechanism for determining the number of shares to be issued upon conversion, namely discounts and valuation caps.

Venture debt

Japan's venture debt market has experienced rapid growth in recent years, with financial institutions introducing a variety of venture debt arrangements with diverse terms. Venture debt, a type of financing primarily aimed at start-ups, is gaining attention as a funding alternative to equity financing. Unlike traditional loans, it is characterised by its evaluation of future growth potential and technological capabilities. Some experts predict that the Japanese venture debt market could expand from its current scale of approximately JPY200 billion to over JPY1 trillion within the next five years. The market is also seeing increased diversification of players, with independent venture debt providers entering alongside traditional banks and securities firms, intensifying competition. Each financial institution offers venture debt arrangements with varied terms, including CBs and loan agreements combined with stock acquisition rights.

In addition, in order to encourage financial institutions to take initiatives in cash flow-based lending to start-ups and other entities, the *"Act on the Promotion of Cash Flow-Based Lending"* was enacted in June 2024 (scheduled to take effect at some point in spring of 2026), which creates a new type of security interest called the *"Enterprise Value Charge"*. This will allow even start-ups with limited tangible assets to have their intangible assets, such as know-how and customer base, included in the valuation of collateral, thereby increasing the ability of start-ups to obtain debt financing. This is also expected to increase lenders' interest in the start-up's business, leading to timely lender support for the start-up's business improvement.

Stock options as incentives

While recruiting talented people is essential for start-ups to grow, Japanese start-ups often grant stock options (the precise legal name for these rights is stock acquisition rights) to their directors and employees as an incentive. While there is a variety of different types of stock options, the one most often used for start-ups is the tax-qualified stock option. If the legal requirements for a tax-qualified stock option are met, holders are not taxed when they exercise the stock

option, and the tax is deferred until the time the shares are transferred, with the entire economic gain treated as capital gain and subject to a lower tax rate.

The following notable changes have been made in recent years to make tax-qualified stock options more effective and attractive.

- The exercise period for tax-qualified stock options is, in principle, from between two and ten years from the date of the resolution to grant, however, for unlisted companies that have been established less than five years, the termination period was extended in 2023 to 15 years after the resolution to grant. This has made it easier to use stock options even for deep-tech start-ups that require more time to reach exit.
- In 2024, the maximum annual exercise price for tax-qualified stock options was raised, up to JPY36 million, three times the previous maximum (provided for companies less than five years old, up to JPY24 million, double the previous maximum). This revision will contribute to securing human resources by start-ups at a later stage, where the exercise price of stock options tends to be higher. In addition, while it was previously mandatory to entrust the custody of shares issued upon the exercise of stock options to a securities company and others, start-ups are now allowed to manage their own shares so that it has become easier to maintain tax-qualified requirements when an M&A transaction occurs.

In addition, rules for more flexible issuance of stock options were also created by a special amendment to Japan's Companies Act in 2024. Start-ups that have been approved by (i) the Minister of Economy, Trade and Industry and (ii) the Minister of Justice, by a resolution of a shareholders' meeting, may delegate to the directors (if a start-up has a board of directors, to the board) the determination of the exercise price and exercise period for the stock options, which, in general, is required to be determined at the shareholders' meeting, and such delegation will be valid for 15 years from the establishment of the start-up (in general, only one year from the date of the resolution).

Startup Visa

The Startup Visa system was established to revitalise Japan's economy by attracting foreign entrepreneurs with innovative business models and technologies, thereby promoting innovation. Under this system, the Regional Immigration Services Bureau grants residency to foreign nationals who receive management and support for their entrepreneurial preparatory activities from local governments or private businesses accredited by the Minister of Economy, Trade and Industry. Compared to the traditional *"Business Manager"* visa, requirements such as those relating to initial capital and employment have been relaxed. Furthermore, the maximum residency period for foreign entrepreneurs has been extended from one to two years, allowing for more comprehensive and relaxed start-up preparation.

Exits

One significant characteristic of start-ups in Japan is that they often opt for IPOs rather than M&A as a means of exit. This preference is largely due to the perception among Japanese start-ups that IPOs offer a more definitive path to success, especially considering the lenient listing requirements of the Tokyo Stock Exchange Growth Market, which is accommodating compared to global standards. According to a survey by the Venture Enterprise Center, Japan, the

ratio of IPOs to M&A in Japan is approximately 7:3, whereas in the USA, M&A predominates with a ratio of approximately 1:9.

Furthermore, unlike in the USA, the secondary market for unlisted companies is not active in Japan, thereby limiting the exit options available compared to the USA.

In recent years, development of the secondary market has been under consideration and necessary disclosure rules have actually been put in place and, along with some regulations having been eased, it is anticipated that the expansion of exit options and opportunities for start-ups in Japan will bring about further investment from VC and other sources, leading to continued growth and success for Japanese start-ups.

MALTA

Law and Practice

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1. Trends

1.1 VC Market

From the publicly disclosed transactions, the largest VC-related transaction pertains to Xensam, which is a technology provider of AI-driven cloud-based software asset management. It raised USD40m in growth funding from Expedition Growth Capital. Additionally, AirX Charter which is a Malta-based luxury charter airline closed a Series A funding round and has successfully raised approximately USD35 million to acquire four additional aircrafts. The company is also preparing for a larger Series B funding round.

As for exists, High Roller Technologies which is a US-based company with a strong Maltese presence, filed with the Securities Exchange Commission in the United States to raise USD14 million in an initial public offering.

1.2 Key Trends

Malta has always been a pivotal jurisdiction for start-ups and SMEs and has seen substantial growth in the past decade from a number of key industries. With Malta's focus on specific high-value sectors, Malta has managed to attract significant foreign investment. It is thus no surprise that in the first half of 2024, Malta attracted over EUR13 billion worth of foreign direct investment (FDI) from January-June 2024, resulting in Malta's total stock of FDI totalling approximately EUR466 billion at the time. Local and foreign start-ups continue to invest in Malta due to several key government-promoted incentives or favourable legal frameworks. This makes Malta an ideal jurisdiction for VC growth, which has seen significant increases in recent years.

Malta has not been particularly affected by the globally subdued VC market due to the small size of its economy, and while VC in Malta is still considered to be at its infancy, the jurisdiction has immense potential for VC investors to invest in Malta-based companies. Malta already provides significant assistance to start-ups, with the Malta Enterprise managing numerous programmes and incentive schemes to encourage local investment. Such incentives have taken a significant drive forward in 2024, with the Maltese government issuing the Seed Investment Scheme, which allows eligible companies access to up to EUR250,000 in tax credits, and Start-Up Finance Schemes, which provide assistance to a maximum of EUR1.5 million. These schemes are coupled with wider financing opportunities as the government has also announced the creation of a EUR10 million VC fund to assist innovative start-ups. There are

also various residence schemes for high net worth or highly skilled individuals to relocate to Malta. These incentives, in addition to Malta's very attractive tax system, which allows foreign-owned corporates effective corporate tax rates as low as 5%, make Malta an ideal jurisdiction for start-ups to grow and thrive, and for VC investors to invest in. These incentives also allow foreign SMEs to establish a strong base of operations in Malta and to benefit from these incentives, making them more attractive to VC investors. Such trends are quite common and, subsequently, many innovative start-ups are acquired by larger entities or attract significant foreign investment. Such investments can occur either through VC funds acquiring an interest, or through setting up separate corporate entities by the investor to invest in the project and benefit from some of the incentives available.

1.3 Key Industries

Malta has seen substantial growth in various high value industries in recent years. These include gaming, aviation, financial services, crypto-assets, software development and technology. In a survey carried out by the Europe Startup Nations Alliance (ESNA), Malta was ranked as the fourth best destination for innovative start-ups and over the past few months over 300 start-ups have launched, which have added over EUR1.2 billion into the economy. Malta's location is also a key element allowing certain industries to flourish as it is seen as a gateway to both Europe and Africa.

The gaming industry in Malta has become critical and contributes more than 12% towards the country's GDP. In this regard, various start-ups have been launched from Malta to provide B2B or B2C gaming services. Such enterprises are a prime target for VC investors seeking to invest in the industry due to the potential growth. This can be seen with companies such as Just Slots, a B2B gaming services provider, which managed to acquire over EUR1.1 million in seed capital in 2024.

Talent coming out of the University of Malta is also significantly contributing to start-up growth at the local level. Start-ups founded by alumni have significantly contributed to enterprise value, which today exceeds EUR1.5 billion from 2019. Such projects have also raised EUR260 million in VC in recent years.

Lastly, entities licensed by the Malta Financial Services Authority (MFSA) have seen significant growth in recent years with several financial start-ups choosing Malta for regulatory licence acquisition to provide financial services into the EU. Malta, which was also dubbed *"the Blockchain Island"* few years ago, had significant growth in the crypto-asset sphere and, with the Markets in Crypto-Assets Regulation (MiCAR) coming into force, Malta is one of the only jurisdictions to be MiCAR-ready from day one. It is anticipated that such industries will also attract VC investors in the coming years.

2. Venture Capital Funds

2.1 Fund Structure

In Malta, VC funds are typically structured using various legal vehicles, with the following two being the most prevalent.

- Investment company with variable share capital (SICAV): this is the most common structure of VC funds due to the significant flexibility offered by SICAV structures. A critical element of the SICAV is its open-ended structure, meaning that its share capital can be modified. The SICAV structure permits a

wide variety of investment strategies, making it a popular choice for Maltese funds.
- Investment company with fixed share capital (INVCO): INVCOs are far less popular that SICAVs due to its fixed share capital, often referred to as *"close-ended"* structure. INVCOs also have various restrictions on their activities, allowing the SICAV to be by far the most popular investment structure.

SICAVs also allow for a great level of flexibility that alternative legal forms do not provide. Primarily, SICAVs can be structured in an umbrella fund structure, which allow for multi-funded investment vehicles and sub-funds under the primary fund. A SICAV can also be established as a Recognised Incorporated Cell Company (RICC), which allows each sub-fund under the primary fund structure to be set-up as separate incorporated cells, which have their own separate legal patrimony.

The law also allows for funds to be structured into Partnerships, Unit Trusts, and Common Contractual Funds, however, they are rarely used as structure for a fund.

As for the regulatory structure, professional funds are either regulated under the European-wide Alternative Investment Fund Managers Directive (AIFMD), with funds being legally recognised as Alternative Investment Funds (AIFs), or under the local fund regime for professional investors, where such funds are known as Professional Investor Funds (PIFs). Retail fund structures are excluded from these frameworks.

PIFs serve as a flexible and efficient vehicle for VC investments as they are primarily designed for professional or qualifying investors, benefiting from a regulatory framework that allows fund managers to adopt innovative and tailored investment strategies. They offer a cost-effective and tax-efficient structure, making them an attractive option for VC firms looking to invest in start-ups and high-growth companies. PIFs have less regulatory requirements than AIFs but are not subject to the single market passport and hence cannot be marketed outside of Malta without obtaining the necessary regulatory licence.

As for the corporate documentation, each fund will have a statute, the form of which will depend on the fund's legal structure. A SICAV or INVCO will have its own Memorandum and Articles of Association (MAA), which are often supplemented by a separate shareholders agreement. The fund will then issue an offering memorandum, which will list the key details of the fund, its investment objectives, investment strategy and other key terms. Lastly, investors will enter into a subscription agreement with the fund. The agreement sets out the terms of the investment.

2.2 Fund Economics

In Malta's VC landscape, Fund Principals – comprising initiators, managers and principals – engage economically with the funds they oversee through a combination of management fees, performance incentives, and personal capital commitments.

- Management fees: Fund Principals typically receive an annual management fee, which is a percentage of the fund's committed capital. This fee compensates for operational expenses, including salaries, due diligence and administrative costs. The exact percentage can vary based on the fund's size and the management team's expertise.
- Performance incentives (carried interest): in addition to management fees, Fund Principals often receive carried interest, a share of the

fund's profits after investors have recouped their initial investments. This performance-based incentive aligns the interests of Fund Principals with those of the investors, promoting diligent fund management.
- Personal capital commitments: to further align interests, Fund Principals may invest their own capital into the fund. This practice demonstrates confidence in the fund's potential and ensures that Fund Principals share in both the risks and rewards alongside other investors.

The MFSA emphasises robust corporate governance within the financial sector, including VC funds. The primary legislative framework is the Companies Act, which delineates the responsibilities of directors, shareholder rights and transparency obligations. Complementing this, the MFSA has introduced several codes and manuals to guide governance practices.

- Corporate Governance Code: applicable to all unlisted entities authorised by the MFSA, this code provides principles and provisions to be applied on *"best effort"* basis, promoting responsible and efficient management for long-term success.
- MFSA Corporate Governance Manual for Directors of Collective Investment Schemes: targeted at directors of collective investment schemes, including VC funds, this manual offers guidance on implementing good governance practices. It covers aspects such as the role of directors, board composition, meetings and crisis management.

These frameworks underscore the importance of the following.

- Board composition: ensuring that boards include directors with the requisite skills and experience, with an emphasis on appointing independent directors to enhance objectivity and oversight.
- Regular board meetings: conducting meetings at least quarterly to review the fund's performance, operations, and compliance with investment strategies and regulatory requirements.
- Risk management and compliance: implementing robust systems to identify, assess and manage risks, including financial crime prevention and adherence to anti-money laundering regulations. By adhering to these governance standards, VC funds in Malta aim to balance the economic interests of Fund Principals with investor protection, fostering a transparent and accountable investment environment.

2.3 Fund Regulation

In Malta, VC funds are subject to regulation under the Investment Services Act (ISA), which provides the legal framework for investment services and Collective Investment Schemes (CIS). The MFSA is the primary regulatory body overseeing these activities. The ISA encompasses various subsidiary legislations that address different aspects of investment services, including the establishment and operation of collective investment schemes.

As a member of the EU, Malta has also implemented the AIFMD, which regulates managers of AIFs, including VC funds. The AIFMD sets out requirements for authorisation, operation and transparency for AIF managers operating within the EU.

Additionally, Malta has adopted the European Venture Capital Funds (EuVECA) Regulation, which provides a framework for qualifying VC funds to market their funds across the EU under

a unified label. This Regulation aims to facilitate cross-border fundraising and investment in SMEs.

As an alternative to the heavily regulated AIFs, Malta offers the local PIFs, which are specialised collective investment schemes governed by the ISA, designed for professional and high net worth investors. They offer a less regulated alternative to retail investment funds, which make them attractive for non-traditional investments. To qualify, investors must commit a minimum of EUR100,000 and meet specific financial criteria, including possessing net assets exceeding EUR750,000 or being a senior employee or director of a service provider to the PIF.

Malta also offers two streamlined fund structures for non-retail investors; these are the Notified Professional Investor Fund (NPIF) and the Notified Alternative Investment Fund (NAIF). NPIFs were introduced by the MFSA and were designed to complement Malta's existing fund structures, particularly benefiting sub-threshold asset managers. On the other hand, the NAIF framework provides an expedited route for AIFs to enter the market.

2.4 Particularities

Malta's VC landscape has experienced significant growth, marked by strategic initiatives and evolving fund structures aimed at fostering innovation and accommodating extended investment horizons. These include the following.

- Government-backed VC funds: in September 2023, the Maltese government introduced a EUR10 million Venture Capital Fund to provide equity investments in innovative technology start-ups. Managed by Malta Government Investments through Malta Government Ventures, this fund targets sectors such as video game development, fintech, e-sports, life sciences and green energy. Eligible start-ups can receive up to EUR500,000 in equity investment, with plans to support approximately 20 companies over two years.
- Special Limited Partnership Funds (SLPFs): in February 2025, the MFSA introduced the Special Limited Partnership Fund framework. This structure allows for Collective Investment Schemes structured as Limited Partnerships without separate legal personality, offering flexibility and tax efficiency. SLPFs are particularly suited for private equity and VC funds, providing a versatile vehicle that aligns with international best practices.
- Malta Private Equity and Venture Capital Association (PEVCA Malta): launched in March 2024, PEVCA Malta aims to promote and support the development of the private equity and VC industry in the country. By bringing together investors, fund managers and service providers, the association seeks to enhance Malta's profile as a destination for private equity and VC activity.
- Fund strategies for extended holding periods: to address extended average holding periods for investments, Maltese VC funds are adopting several strategies. Utilising frameworks like SLPFs allows for customisable governance arrangements and profit-sharing mechanisms, accommodating longer investment horizons.
- Continuation funds: while specific data on continuation funds in Malta is limited, the evolving regulatory environment and the introduction of flexible structures like SLPFs may facilitate the establishment of such funds to manage assets requiring extended holding periods. These developments reflect Malta's commitment to nurturing a dynamic VC ecosystem, supporting innovation, and

adapting to the evolving needs of investors and entrepreneurs.

3. Investments in Venture Capital Portfolio Companies

3.1 Due Diligence

The due diligence process carried out is very similar to due diligence carried out under standard M&A situations, albeit with a different focus and objectives. Various technical experts are engaged to carry out due diligence on specific parts of the business subject to the potential acquisition. Accountancy and audit firms are engaged for financial due diligence on the books of the enterprise. Law firms are engaged for the legal due diligence and technical experts are engaged to carry out due diligence on other assets such as technology or intellectual property. A tax compliance assessment is also typically carried out to ensure that the enterprise is compliant with its tax obligations.

It is standard practice that prior to engaging the legal and technical experts, the business model of the enterprise is primarily assessed, to ensure that the target has sustainable potential growth prospects. Scrutiny of key individuals in the industry is also common. In local SMEs targeted by VC investors, most of the critical work is carried out by the founders and their initial team and hence a certain level of scrutiny is carried out on these individuals. Time commitments are also often required by the founders to ensure that such key members of the enterprise do not abandon the project in the medium term.

Following an agreement on the financials, legal firms are often engaged, along with other technical experts, depending on the enterprise. Any legal due diligence carried out is typically *"red flag"* exercise, with specific focuses on the legal structure of the company, regulatory compliance, tax compliance, employment law, data protection, legal agreements, intellectual property, debt agreement, active securities and warranties, as well as litigation. Such exercise will be subject to materiality and relevance thresholds and often involves multiple jurisdictions because Maltese companies are typically used in multi-jurisdictional structures and have numerous companies in various jurisdictions, even in SMEs.

Additional scrutiny is also carried out on specific company assets, specifically when the company's main asset is intellectual property. Technical experts are often also engaged to assess the technical architecture and, depending on the industry, any required security aspects of the technology. For instance, in the crypto-asset, gaming or payment industry, technical security is a critical element of the technical asset.

3.2 Process

The timeline typically varies from weeks to months, and the duration thereof is dependent on a number of factors as follows.

- The time needed for the investors to come to a financial agreement on factors such as the acquisition price, share of profits, equity share and shareholder rights.
- The drafting of any required preliminary agreements/terms sheets, memorandums of understanding which may or may not be required as part of the process, and any negotiating time required to agree on a final text.
- The time needed to conduct any required due diligence. This timeline could be extended if the information provided lacks sufficient detail as well as in situations where the due diligence uncovers certain issues which would

need to be resolved prior to the finalisation of the deal.
- The drafting and negotiation of key legal documents such as the share purchase agreements, shareholders agreements, amendments to the MAA of the company, and others.
- If the target is licensed by a regulatory authority such as the MFSA or the MGA (Malta Gaming Authority), such agreement needs to be notified and approved by the relevant authorities before it can proceed. This authorisation may take some time depending on the extent of the change. The investors are also subject to significant due diligence requirements by the regulatory authorities. This submission may also require additional specific documents, such as an updated business plan, if the target will substantially change its business model following the investment.
- The preparation, execution, filing and registration of the final transfer documents which need to be registered with several authorities, such as the Malta Business Registry and the tax authorities. This is a formality, but the process may be time consuming.

Similarly to a traditional M&A transaction, the interests of all the parties need to be balanced and safeguarded to ensure that the transaction is finalised. While the investor will seek to enhance their potential investment, the original owners will seek legal protections and assurances. Such agreements would then be governed through shareholders' agreements between the parties. Share class and class rights are also very common in such transactions, and these serve to distinguish between the different classes of owners. Class rights carry different voting rights, dividend rights and so forth. The negotiating phase is hence critical as both sides of the transaction need to agree on the terms of the deal, which can also impact the timeline of the transaction. While the due diligence process would require more hours to complete, negotiations with investors typically take longer due to various interests which need to be aligned, as well as due to the multiple advisors required on each front.

3.3 Investment Structure

There are various options for investors in early-stage financing to invest in a company, other than ordinary shares. In all cases, this is done through different classes of shareholding, which include the following.

- Preference shares: these shares offer holders a preferential dividend at a fixed rate. Holders of preference shares are not considered equity holders and are paid dividends before any are paid to ordinary equity holders. Investors are allotted preference shares when they want to invest monies into an enterprise but want a fixed rate of return, which is paid before any dividends to ordinary equity shareholders.
- Convertible preference shares: these shares have the same elements of ordinary preference shares but are convertible to ordinary shares or a specific class of ordinary shares on the occurrence of a specified event. This would allow preference shareholders to become equity shareholders on the materialisation of certain events.
- Participating preference shares: these shares have the same elements of ordinary preference shares but also provide the right to receive an additional dividend which ranks equally with ordinary shareholders.
- Redeemable preference shares: these shares have the same elements of ordinary preference shares but can be redeemed upon a decision being taken or upon the materialisation of a specified event.

- Pre-emption rights: these rights are provided to all or to specific classes of shareholders to the effect that should another shareholder wish to sell their shares, these shares must first and foremost be offered to the other shareholders at the same price and conditions as those offered to third parties.
- Dilution protections: similarly to pre-emption rights, anti-dilution provisions are typically inserted to ensure that in the event that the company would like to increase its share capital and allot new shares, such shares are first offered to the current shareholders so as not to dilute their stake in the company.
- Drag-along and tag-along rights: these rights are typically granted to shareholders to ensure that investors are allowed a fair exit opportunity in the event that a majority shareholder would like to exit their investment. Such rights allow the remaining shareholders to sell their shares or for the majority shareholder to force the minority shareholders to sell their investment at the same price and terms as the majority shareholder.
- Transfer restrictions: such restrictions, akin to the pre-emption rights, are inserted to restrict potential sales to third parties, typically in early-stage financing to ensure that the founders do not exit the company before the enterprise has fully developed.
- Voting limitations: various kinds of voting limitations can be included under different share classes. These would include shareholders with no voting rights, shareholders with veto rights, rights to appoint directors by specific shareholders, and other similar rights.

3.4 Documentation

The typical documents in a such a transaction are as follows.

- The initial MOU/terms sheet/preliminary agreement: an initial non-binding agreement is typically used in the initial phase of the negotiations of an investment transaction. This is common in VC transactions as well as in traditional M&As. The document is usually not binding, however specific binding provisions such as those related to confidentiality may be inserted.
- The share purchase agreement: the share purchase agreement is a formal agreement between the sellers and the buyers which formally sets out the rights and obligations of the parties in a share transfer transaction. The document would typically contain various provisions on intellectual property, warranties and restrictive covenants, amongst others. This document is a private document, and a separate short form share transfer instrument is utilised when registering a transfer with the authorities.
- The shareholders' agreement: the shareholders' agreement is a private document, signed by the shareholders, which deals with various aspects of the company such as specific share rights, income rights, decision making, governance and management. The shareholders' agreement is frequently used to ensure that certain arrangements remain private and is common in any form of investment transaction.
- The MAA: the memorandum is the statute of the company, the general format of which is standard. While the articles of association allow for a great deal of customisation, the memorandum of association has a predefined format which must be followed, as specific clauses must be inserted as a matter of validity. The MAA can have specific provisions related to share rights, governance and management, but these are often listed in private shareholders' agreements. If the company

decides to have various share classes as a result of the transaction, these must be listed in the memorandum of association of the company. The document is public and can be accessed by anyone at will.
- The standard registration documents: this is a set of documents mandated by law which are required to formally register a transfer of shares in a company in Malta. These include statutory standard registration forms from the Malta Business Registry, standard duty and capital gains taxation forms and a short form share transfer instrument. These are not required if the transaction has occurred in a holding company outside of Malta, although if such transfer resulted in a change of beneficial ownership, a specific notification form must be filed in Malta.

3.5 Investor Safeguards

There are various key protections that investors can attempt to secure when investing in an enterprise. Essentially, all such measures are treated through share classes, and, to that effect, specific classes of shares are created which hold different rights, including those listed below.

- Pre-emption rights: these rights ensure that in the event of a transfer of shares, such shares are not offered to third parties outside the company, without first being offered to other shareholders. Various mechanisms and rankings can be implemented on who gets offered shares first, and there are different pricing mechanisms that can also be used.
- Dilution protection: these rights are similar to the pre-emption rights, but apply when new shares are issued. When a company issues new shares, such shares shall be offered first to current shareholders based on specific ranking and pricing mechanisms.
- Drag-along/tag-along rights: these rights ensure that, in the event of a potential transfer by the majority shareholder, certain exit guarantees are put in place. Such provisions ensure that the company can be sold as a whole to a potential acquirer, hence ensuring that minority shareholders can exit when a total change in ownership takes place, and also allowing the buyer to eliminate minority shareholders.
- Reserved matters: in certain situations, shareholders agree that a number of matters should be reserved for the shareholders to decide on, rather than the directors, such as the sale of major assets or intellectual property. While such a decision would normally be taken by the board, the shareholders may determine that such a decision is too important and should be decided by the shareholders themselves.
- Board influence: it is also quite common that shareholders opt to have representation at board level, and special rights are granted to specific classes of shareholders to appoint their own director at that level too.
- Voting rights: different voting rights are also common. Share classes can be created to differentiate between the voting power of shareholders. However, this requires proper structuring, as not all decisions are equal and providing various voting rights at different levels may require modification to the nominal value of the shares.
- Veto rights: in certain instances, veto rights are created to ensure that certain decisions cannot be passed unless agreed to by specific share class majorities.

Under law, there is also a legal remedy called *"the unfair prejudice remedy"*, which is an umbrella protection for shareholders in the event that certain decisions are taken by the company

which unfairly prejudice their right. This is a very flexible and dynamic remedy with varying consequences.

3.6 Corporate Governance

The extent of influence on decision making power by the investors would depend on the agreement reached between the parties, on the number of different investors, as well as the amount invested by the investors. This influence is typically exercised through the rights outlined below.

- The parties may agree on the investors having direct board representation, which may be either an executive director or a non-executive director, depending on the extent of the influence agreed to between the parties.
- Quorum requirements are also very common to ensure that valid meetings cannot be held if certain categories of shareholders are not sufficiently present. This ensures that even if the investors have voting rights, decisions are not taken without their knowledge or involvement.
- It is also possible to appoint an observer, which allows an individual to attend certain meetings without being exposed to the fiduciary duties of a director. It is important to note that although, in practical terms, there is a difference between executive and non-executive director, legally, they are subject to the same level of exposure or liability.
- As mentioned at **3.5 Investor Safeguards**, different voting rights, reserved matters and veto rights are also often used by investors to enforce their influence.

The parties may agree to various other measures to ensure transparency. These would be agreed to in the shareholders' agreement, addendums or supplements thereto.

3.7 Contractual Protection

On the conclusion of the financing deal, several contractual protections are typically agreed to between the parties, which may be split as follows.

- Representations and warranties: a standard set of provisions in such agreements would consist of numerous generic and specific warranties from both parties when entering into such transaction. These warranties would cover potentially anything, from past liabilities and damages, as well as representation regarding certain facts or disclosures. A breach of those warranties would entitle the other party to potential damages. Due to the specific nature of such warranties, it is also possible to bind the founding shareholders as jointly and severally liable alongside the company, so that the investor would have redress against individuals rather than the entity alone. This serves to prevent a situation where the company pays damages to the investor from the investor's own funds. It also allows the investor to take action against the shareholders directly in the event of corporate insolvency. In insolvency proceedings, the law of rankings may result in a situation that after preferential creditor claims are satisfied, the investor has no assets to resort to, hence joint and several liability protects the investor from such a possibility and gives the investor further forms of redress.
- Restrictive covenants: non-compete and non-solicitation provisions are also very common in investor agreements to ensure that the investor does not start a competing business using the knowhow obtained from the start-up. Non-solicitation of employees and key staff are also fairly common to protect the company's human resources. Likewise, strong intellectual property clauses are typi-

cally in place to prevent intellectual property misappropriation. The same scenario is applicable to the founding shareholders, so that they do not start competing enterprises to the detriment of the investors.
- Damages and liability: the shareholders' agreement often contains specific breach and indemnity provisions to protect the investors. In certain instances, the parties may agree on pre-liquidated damages provisions, although this is not very common due to the effect of such damages on the relationship.
- Non-circumvention provisions: non-circumvention provisions are also common in such agreements to avoid potential issues when related parties, such as family members or other entities, are utilised to circumvent obligations, especially those related to restricted covenants.

4. Government Inducements

4.1 Subsidy Programmes

Malta offers several government and quasi-government programmes designed to incentivise equity financing in growth-oriented companies. These initiatives aim to support start-ups and SMEs through various forms of financial assistance and tax incentives. These programmes include the following.

- Start-Up Finance Scheme: administered by Malta Enterprise, this scheme provides financial support to small start-up undertakings with specific innovative activities. Eligible start-ups can receive a re-payable advance of up to EUR500,000, which may increase to EUR1 million for innovative enterprises. For those operating in designated assisted areas, the support can reach EUR750,000, doubling to EUR1.5 million for innovative start-ups. The funds can be utilised for payroll expenses, procurement of tangible and intangible assets, specialised services, and establishing operations in Malta.
- Seed Investment Scheme: this scheme was re-introduced in 2024 and offers tax incentives to individual investors who provide equity financing to qualifying start-ups. Investors can benefit from a tax credit amounting to 35% of their investment, up to a maximum of EUR250,000 per annum. A qualifying company can raise up to EUR750,000 through this scheme. To be eligible, companies must be incorporated in Malta, unlisted on any recognised stock exchange, have fewer than ten employees, possess gross assets under EUR250,000, and have been in operation for less than three years.
- SME Guarantee Scheme: managed by the Malta Development Bank, this scheme facilitates access to bank financing for SMEs by offering an 80% loan guarantee through authorised financial intermediaries. Family businesses and other SMEs can obtain loans ranging from EUR10,000 to EUR750,000, with repayment terms of up to ten years and an optional 12-month moratorium. This support is particularly beneficial for businesses lacking sufficient collateral or credit history.
- Micro Invest Scheme: offered by Malta Enterprise, the Micro Invest Scheme encourages SMEs to invest in innovation and expansion. The scheme provides tax credits on eligible expenditures such as infrastructure improvements and wage costs. Businesses can receive tax credits of up to EUR70,000 over a three-year period, which can be used to offset their tax liabilities.
- Business Development Scheme: the scheme targets new business ventures, expansions and transformation activities that foster new opportunities, create skilled employment,

enhance competitiveness and broaden market reach. Eligible projects encompass various categories, including the establishment, expansion and modernisation of activities such as manufacturing, software development, waste recycling, research and development and audiovisual productions. Additionally, the scheme supports environmental initiatives, innovative start-ups, employment of workers with disabilities, collaborative projects, upgrading of industrial sites and hotels, artisanal facility enhancements, business re-engineering, digital transformation, and market access and certification efforts. Applicants can receive assistance in the form of tax credits, cash grants or a combination of both, covering up to 75% of eligible expenses, with a maximum of EUR300,000 per single undertaking over a rolling three-year period. Eligible costs include wages, rental fees, advisory services, as well as the acquisition of tangible and intangible assets.

- Research and Development Scheme: also offered by Malta Enterprise, this scheme aims to support businesses in conducting industrial research and experimental development projects. This initiative aims to address scientific or technological uncertainties, fostering the creation of innovative products and solutions. Eligible enterprises, including limited liability companies, partnerships and co-operatives, can receive aid in the form of cash grants or tax credits. The assistance covers a percentage of eligible costs, such as personnel wages, equipment, contractual research and other operating expenses, with aid intensities varying based on the project's nature and the size of the enterprise.
- Innovate (Innovation Aid for SMEs) Scheme: the scheme aims to bolster innovation among SMEs in Malta. This initiative provides financial support for projects that lead to product, process or organisational innovation. Eligible SMEs can receive funding covering up to 50% of qualifying costs, capped at EUR250,000 per application. For specific innovation advisory and support services, funding can reach 100%, with a cap of EUR220,000 over a three-year period. The scheme supports expenses related to the secondment of highly qualified personnel, innovation advisory services and innovation support services. Applications must be submitted before the project commences, with projects required to start within 12 months of approval and complete within a maximum of 36 months.
- Exploring Research Grant: offered by Malta Enterprise, this grant is designed to assist businesses in conducting feasibility studies for prospective R&D projects. These studies aim to evaluate the technical, operational and commercial viability of proposed R&D initiatives, helping enterprises identify potential risks and necessary resources. Eligible applicants include limited liability companies, partnerships and co-operatives that are not defaulting on income tax, VAT and social security payments, and are not classified as undertakings in difficulty. The grant provides up to EUR100,000, covering a varying percentage of eligible costs, being 50% for large enterprises, 60% for medium-sized enterprises, and 70% for small enterprises. Qualifying expenses encompass wage costs for researchers and technical staff, costs for contractual research and technical knowledge, and other operating expenses directly related to the feasibility study.

4.2 Tax Treatment

In Malta, investments in growth, start-up or VC fund portfolio companies are subject to specific tax treatments designed to encourage such

investments. These treatments often differ from the standard tax regime applicable to all companies.

Tax Classification of Funds

From a tax perspective, funds are classified as prescribed or non-prescribed. A prescribed fund is considered as such if it holds at least 85% of the value of its total declared assets in Malta, and has been classified as such by the Commissioner of Inland Revenue. The most notable difference is that a prescribed fund is taxed at the standard corporate rate of 35% whereas the income which is derived by a non-prescribed fund is exempt from Malta tax. If a fund does not meet these conditions, it will be defined as a non-prescribed fund.

Taxation of Funds

Prescribed funds are taxed based on the source of their income:

- 10% final withholding tax is levied on investment income paid by companies and other legal entities, as well as on bonds issued by listed companies and on interest, discounts or premiums earned on Malta government stocks or bonds;
- 15% final withholding tax is levied on bank interest income;
- 35% tax is levied on income derived from immovable property situated in Malta;
- no tax is paid on income which is not sourced in Malta;
- no tax is levied on dividends from Maltese companies or from other funds; and
- no capital gains are levied on disposal of securities.

On the other hand, non-prescribed funds fall out of scope and are not taxed at fund level, except on gains from immovable property situated in Malta.

The tax treatment of funds is completely different from the standard corporate taxation system.

4.3 Government Endorsement

The Maltese government has implemented several significant initiatives to enhance equity financing activities, particularly focusing on supporting SMEs and start-ups.

Malta Development Bank (MDB)

The MDB aims to bridge financing gaps by complementing private sector financial services. It offers various financial instruments, including loans, guarantees and equity participations, in an effort to support SMEs, infrastructure projects and environmentally sustainable initiatives. The MDB collaborates with commercial banks to facilitate access to finance for businesses that may face challenges in securing traditional funding.

Collaborations with the European Investment Fund (EIF)

Malta has partnered with the EIF to bolster SME competitiveness through the InvestEU Member State Compartment. In October 2024, the EIF signed a EUR30 million agreement with the Bank of Valletta, aiming to unlock EUR60 million in investments for over 140 businesses. This initiative provides SMEs with improved financing conditions, such as lower interest rates and reduced collateral requirements.

Malta Enterprise

As the government's economic development agency, Malta Enterprise offers various schemes to support businesses as outlined at **4.1 Subsidy Programmes**.

EUR10 Million Fund to Support Innovative Start-ups

A VC scheme has been introduced by the Maltese government to assist new companies which find it difficult to receive bank loans due to risk factors. Eligible companies may include those involved in video game development, fintech, e-sports, life sciences, pharma, green energy, the filming industry, agritech, AI, communications, electronics, financial services, medical devices, software, blue-water industries and digital technology.

5. Employment Incentives

5.1 General

In Malta, founders' and key employees' long-term commitment to a venture is typically secured through a combination of equity-based incentives, contractual provisions and retention-focused remuneration schemes. One common method is the issuance of shares, often accompanied by specific provisions in the company's MAA or a private shareholders' agreement, the provisions of which would typically supersede those of the MAA. Notably, the latter is only binding if all shareholders are parties to the agreement.

Vesting provisions are frequently incorporated to ensure retention, with shares being allocated over a predetermined period or upon meeting performance milestones. These provisions often include clawback mechanisms, allowing the company to reclaim shares if the founder or key employee leaves before the vesting period ends. Employee Share Option Plans (ESOPs) and free bonus share schemes are also popular, often structured with multi-year vesting to promote long-term alignment with the company's growth.

Tax considerations play a crucial role in structuring these schemes. Malta's fringe benefit tax rules apply to share option and free share schemes, impacting the overall benefit received by employees. Additionally, cash-based or phantom share plans offer alternatives to direct equity participation, enabling employees to benefit from the company's success without acquiring actual shares. These arrangements may come with distinct tax implications that need to be carefully assessed.

In the case of listed entities, the requirement to obtain prior written authorisation from the Malta Financial Services Authority before offering such schemes has been recently removed, simplifying the process and encouraging broader adoption of equity-based incentives.

Beyond equity incentives, companies may offer cash-based retention bonuses, more favourable employment terms or a percentage of profits without issuing shares. Employment agreements often include anti-competition clauses to protect the company's interests post-employment. However, the enforceability of such clauses is subject to Maltese court rulings, which underscore the need for carefully balanced terms. Additionally, *"garden leave"* clauses may be used to restrict departing employees from engaging with competitors during their notice period while still receiving compensation.

Overall, a combination of these strategies helps align the interests of founders and key employees with the long-term success of the venture, ensuring stability and commitment while balancing legal, tax and commercial considerations.

5.2 Securities

Companies in Malta commonly use shares, including share option schemes and free share

plans, to incentivise founders and employees. These instruments are typically structured with a vesting period to encourage long-term commitment and align individual performance with the company's growth.

Vesting terms often require continued employment over a set period or the achievement of specific milestones. Reverse vesting mechanisms may be applied, particularly with founders, whereby shares are issued upfront but subject to potential forfeiture if conditions are not met. Clawback provisions further protect the company by allowing the retrieval of shares if the employee or founder departs before the vesting period ends or fails to satisfy ongoing conditions.

In some set-ups, shares are held in a trust during the vesting period as this also facilitates the implementation of any applicable clawback provisions. Depending on the structure, founders or employees may have limited rights over these shares until the vesting process is complete. This arrangement ensures that equity benefits align with long-term performance and retention goals.

Overall, these instruments provide companies with flexible tools to incentivise key individuals, ensuring their interests remain closely tied to the venture's success.

5.3 Taxation of Instruments

When structuring incentive pools in Malta, several tax considerations play a pivotal role in determining their design, particularly concerning tax rates and the timing of taxable events.

Issuance of Shares

The timing of share issuance significantly impacts tax implications. Issuing shares at an early stage when the market value closely aligns with the nominal value may result in minimal immediate tax consequences. However, issuing shares at a later stage, when the company's market value has appreciated, typically involves a share premium. In Malta, this premium is allocated to the share premium account, governed by specific provisions in the Maltese Companies Act. According to the Act, funds in the share premium account can be used for purposes such as:

- issuing fully paid bonus shares to existing shareholders;
- writing off preliminary expenses of the company; and
- providing for premiums payable on redemption of redeemable preference shares or debentures.

These provisions ensure that the share premium is utilised in a manner that maintains the company's capital integrity.

Fringe Benefit Rules

Malta's Fringe Benefit Rules classify benefits like share options and free share plans as taxable benefits. The taxable value is determined by the excess of the market value of the shares at the time the benefit is provided over any amount paid by the beneficiary. This benefit is subject to a flat tax rate of 15%, which employers are required to account for through the Final Settlement System (FSS).

Duty on Documents and Transfers

The transfer of shares in Malta is subject to duty under the Duty on Documents and Transfers Act payable by the acquirer/transferee. The standard duty rate is 2% of the higher of the market value or the consideration paid for the shares. For property companies, this rate increases to 5%. The market value is typically assessed based

on the company's net asset value, adjusted for factors such as the market value of any other shares held by the company. There are instances where a company, and thus the acquisition of shares therein, is exempt from payment of duty. However, this is primarily applicable to companies which have more than 90% of their business interests outside of Malta and which are not ultimately owned or controlled by individuals who are tax resident and domiciled in Malta.

Capital Gains Tax

Upon the sale of shares, capital gains tax considerations arise. In Malta, capital gains derived from the transfer of securities are generally taxed as part of the individual's income, with rates varying between 15% and 35%, depending on the total income. However, certain exemptions exist, such as gains from the transfer of shares listed on the Malta Stock Exchange, which are exempt from both income tax and duty.

Timing of Taxable Events

The timing of taxation varies based on the type of benefit.

- Share options: taxation occurs at the exercise date, calculated on the difference between the market value at exercise and the exercise price.
- Share awards: taxable at the time the shares are issued or transferred to the employee at the end of the vesting period, based on the market value at that date.
- Share transfers: duty is payable upon the execution of the transfer agreement, with the applicable rate depending on the nature of the company (eg, property versus non-property company).

Understanding these tax considerations is crucial for effectively structuring incentive pools in Malta, ensuring compliance and optimising the benefits for both the company and its employees.

5.4 Implementation

There are various considerations to take into account before preparing and implementing employee incentive programmes in Malta. Primarily, the company needs to consider whether such an incentive programme would affect any rights currently held by the shareholders of the company. These are found in the MAA of the company and in the shareholders' agreement, if any. The creation of such schemes usually creates specific share classes to be assigned to the employees participating in such schemes. Any changes to the MAA, or the creation of any share classes, would require approval by the shareholders. The company would also need to assess any fiscal and tax considerations that such schemes would have on the current shareholders and the new employees, as the allotment of new shares may have tax considerations on both the current shareholders and the employee participants of the scheme.

As for dilution of interest, there are options in place to prevent the dilution of certain rights. Employees participating in such schemes would usually have no voting rights and hence the issuing of new shares would not affect voting power. It is also possible for certain employee schemes to be structured through phantom shares, meaning that employees do not become equity holders in the company. However, all these measures would result in the dilution of dividends/income received and therefore any such schemes must be agreed to by the relevant shareholders.

6. Exits

6.1 Investor Exit Rights

There are various mechanisms that shareholders and companies utilise to regulate exit rights between themselves. Such mechanisms are generally also considered to be transfer restrictions, and this impacts how investors are able to divest of any interest in the enterprise. These generally include:

- pre-emption rights;
- transfer restrictions; and
- drag-along and tag-along rights.

These are discussed in detail in **3.3 Investment Structure** and **3.5 Investor Safeguards**.

6.2 IPO Exits

Maltese start-ups or foreign-owned Malta-based start-ups rarely issue an IPO in Malta as the market is very small. In the event that a company is planning for an IPO exit, the company would undergo major restructuring to issue an IPO in a foreign jurisdiction with a bigger market for IPOs. However, Computime, a local IT hardware provider, launched an IPO in 2024 to sell 22,987,600 shares at an offer price of EUR0.45 per share whereby the then current shareholders sold approximately 33% of their shareholding.

6.3 Pre-IPO Liquidity

Investors looking to obtain liquidity would typically engage directly with other investors, rather than through an IPO. The primary market in Malta, being the Malta Stock Exchange, is not active in relation to IPOs for local start-ups.

However, a few years ago, the Malta Stock Exchange set up a secondary market targeted towards local start-ups, namely Prospects MTF. Prospects is specifically designed to assist start-ups to gain access to external finance with less stringent rules and lower costs than the main market. Prospects allows start-ups to seek alternative funding routes, through a less regulated market. However, Prospects allows issues for amounts below EUR8 million, to avoid requiring a prospectus.

7. Regulation

7.1 Securities Offerings

A securities offering, which is deemed to fall under the definition of an *"offer of securities to the public"* will require the issuer to prepare a prospectus as required under the Companies Act. In addition, the issuer also needs to adhere to the capital markets rules issued by the MFSA.

In drafting the prospectus, there are certain key points to be considered.

- The corporate structure: the corporate structure of the issuer and other affiliated entities is essential and, before an issue of any kind, the issuer would undergo major restructuring and consolidation, typically with equity issues, by setting up a holding entity and consolidating all operating companies under it.
- The management body: The composition of the management body is essential for any issue as potential investors would need assurances as to the competence of the board. In main market IPOs, the competence of the management body is also scrutinised and the issuers are legally obliged to ensure that the management body is *"fit and proper"*. Issuers are also obliged to ensure that during an IPO, independent non-executive directors are also appointed as part of the board to ensure a fair balance with non-independent directors.

- Corporate governance: the internal corporate governance and management of the issuer is of critical importance when dealing with an IPO, as they provide a view of the internal workings of the company and certain levels of disclosure would be required as part of the prospectus. These would include internal committees, remuneration policy principles and operational strategy. The disclosure of related party transactions is particularly important, especially with shareholders and directors.
- Tax and fiscal considerations: an IPO, as part of the restructuring mentioned above, would also need to consider any fiscal and tax implications on the operations of the company. With Malta's taxation system, which is greatly geared to benefit foreign investors, issuers of securities in an IPO would need to structure the issue to maximise any tax benefits and reduce tax leakage.
- The financials: the prospectus must contain specific financial information of the company, including past and future projections. Key financial information is critical for the success of an IPO as investors, with an emphasis on institutional investors, would look at these numbers closely. Apart from the general projections, the prospectus would also contain a market analysis and key trends likely to impact the issuer.
- Pre-issue housekeeping: prior to any IPO, the issuer would usually engage lawyers and financial consultants to *"clean up"* its internal legal and financial operations. Such exercise would consist of a due diligence exercise to consolidate the issuer's legal and financial obligations as these would reflect negatively on the issuer.

It is important to note that there are a number of requirements in the capital market rules specifically related to collective investment schemes and, hence, should a VC fund wish to be listed locally, these requirements must also be considered and adhered to.

7.2 Restrictions

Foreign VC investors considering investments in Maltese growth companies should be aware of several regulatory frameworks that may impact their investments.

Malta implemented the National Foreign Direct Investment Screening Office Act 2020 (the *"Act"*), aligning with Regulation (EU) 2019/452, to monitor FDI that could affect national security or public order. This legislation mandates that non-EU investors aiming to establish or maintain lasting and direct links to carry out economic activities in Malta must notify the National Foreign Direct Investment Screening Office (NFDISO) before proceeding with their investments. The scope includes investments enabling effective participation in the management or control of a company engaged in economic activities.

Investors are required to notify the NFDISO if:

- the Maltese entity intends to engage in activities listed in the First Schedule of the Act, which encompasses sectors such as energy, transport, water, health, communications, media, data processing or storage, aerospace, defence, electoral or financial infrastructure, and sensitive facilities;
- the entity will have a non-EU investor who is a beneficial owner or holds a direct or indirect controlling interest; or
- there is a change in the ownership structure resulting in a foreign investor holding at least 10% of the shares.

The notification must include information on:

- the ultimate beneficial owners;
- the source of funding;
- the activities to be undertaken; and
- details on the products, services and business operations of both the foreign investor and the Maltese entity.

Additionally, since Malta's accession to the EU on 1 May 2004, there are no exchange control regulations in place. This means there are no restrictions on capital movements, and no distinction is made between undertakings owned or controlled by EU citizens and those owned or controlled by non-EU citizens concerning exchange controls. However, the Minister for Finance retains the power to impose restrictions on capital transactions in exceptional circumstances to preserve the stability of Malta's financial system.

Lastly, while there are no specific banking-related restrictions that prohibit foreign VC investments, it is essential for investors to ensure that any financial transactions comply with Malta's AML and CTF regulations.

Trends and Developments

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GTG Legal is a corporate and commercial law firm, particularly known for its expertise in technology-related laws, providing clients with comprehensive legal advice in areas such as emerging technologies, AI, cybersecurity, cyber-resilience, IoT, cryptocurrencies, blockchain, data protection, adtech, healthtech, gaming, telecommunications, media, entertainment, intellectual property and ecommerce. Since its founding in 1997, GTG has been at the forefront of Malta's legal profession, bringing together established private practices to form a centre of expertise and excellence. Based in Malta's capital city of Valletta, GTG's ever-growing team of industry specialists is internationally ranked and recognised as a leader across multiple fields, offering a multi-disciplinary approach to service the requirements of local and international clients.

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Market Overview and Investment Trends

The venture capital (VC) market has recently gained significant traction, and is currently experiencing major interest and growth. The local market is being driven by government incentives, a growing interest from foreign investors, and an expanding start-up market. The past few years have seen a rise in the number of deals by VC investors and this is especially relevant in the context of industries such as gaming, fintech, AI, esports and digital infrastructure as a whole.

Investments remain attractive, in the Maltese context, due to Malta's efficient and business-friendly regulatory framework, a favourable tax refund scheme and various government incentives, including various schemes managed by the Malta Enterprise. The first half of 2024 saw Malta exceed EUR13 billion in foreign direct investment, showcasing the increased confidence foreign investors have in the jurisdiction.

Even though Malta's geographical and market dimensions are small, its location and general business-friendly mentality ensure its attractiveness in the European start-up market, attracting significant and constant foreign investment. In 2024, a new EUR10 million VC-co investment fund was introduced in an effort to bring private investment to the country through a mechanism which de-risks early funding.

Key Players Determining VC in Malta

In Malta, VC is backed and driven by a mixture of local and foreign investors, bodies and interest groups, such as:

- VC funds, including GoVenture, AcrossPlus, the Seed Investment Initiative;
- angel investors and other networks, including the Malta Angel Investors Network, Angel-Match.io;
- incubators, such as Malta Enterprise, Malta Digital Innovation Hub and Tech.mt;
- VC initiatives backed by the government, including Malta VC Fund and Accelerate 2024;
- foreign investment funds, such as various UK-based and other EU-based funds seeking to establish a healthy business interest in Malta;
- institutional investors and general private equity firms; and
- government-backed set-ups or local private associations, such as FinanceMalta, Malta Development Bank and the Private Equity Venture Capital Association (PEVCA).

Notable Recent Developments

Notable recent developments which have had an impact on the Maltese VC landscape include the following.

- The launch of the EUR10 million VC co-investment fund: this is an initiative led by the government backing start-ups at the early stages of their business operations by affording them private VC investments.
- The Malta Start-up Residence Programme: This programme, which was introduced in 2023, aims to attract various non-EU investors and skilled personnel. This is significantly aided by a streamlined visa process.
- Various schemes introduced or renewed by the Malta Enterprise, with the aim of promoting start-ups and foreign direct investment in Malta.
- Developments in the regulatory context: the Malta Financial Services Authority (MFSA) and the Malta Digital Innovation Authority (MDIA) continue their efforts to refine processes in order to ensure that start-ups are effectively and efficiently supported, attracting investments in innovative industries such as fintech and AI.

The Maltese VC Legal Framework

An overview of the regulations governing VC

The Maltese regulatory landscape affords a business-friendly environment for the flourishing of VC investments. The legal framework encapsulates the following.

- The 1995 Companies Act: this governs the incorporation, general management principles and the winding-up of companies and other commercial partnerships, together with the workings of corporate structures backed by VC.
- The 1994 Investment Services Act: this Act regulates fund managers, collective investment schemes and investment advisors. It is the primary legislative framework regulating funds and fund managers.
- Various sector-specific legislation, which regulates different sectors. This includes the local gaming laws and regulations, other financial services-related laws as well as the newly implemented Markets in Crypto-Assets Regulation (MiCAR) which regulates blockchain and general investments relating to crypto-assets. Through these laws, Malta has maintained its position as a market leader in this field.

Malta's VC landscape is regulated by a robust framework which aims to align with that adopted across the EU, while offering diverse incentives. The Maltese landscape is such that VC funds in Malta are built as investment vehicles and regulated by the MFSA. It is commonplace for VC funds to be legally structured as investment companies with variable capital (SICAVs). In this regard, these funds would normally operate as Alternative Investment Funds (AIFs), which target investors based on the offering documentation and investment strategy of the fund. To this end, fund managers are to comply with the provisions of the EU's Alternative Investment Funds Managers Directive (AIFMD). Malta provides allows venture capital fund managers that operate on a smaller scale to benefit from de minimis registration under the AIFM regime, provided that they fall below the AIFMD asset thresholds. They may also register under the EU VC Funds Regulation (EuVECA) to obtain a marketing passport which would be valid across the whole EU. In practice, a Malta-based VC fund manager is afforded the possibility of setting up in an efficient manner, by obtaining authorisation from the MFSA, and subsequently open the market for EU investors.

Funds may also be licensed as Professional Investment Schemes (PIFs), a local licensing regime for funds providing significant flexibility and lower regulatory requirements for funds targeting professional investors. This comes at the cost of the fund not being able to be passported throughout the EU.

The setting up of a VC fund requires that a specific application is submitted to the MFSA, which must include an offering document, investor disclosures and a detailed account of internal policies. Funds would also need to identify key individuals or service providers involved in the operation of the funds, in addition to their board of directors and shareholders, and submit specific documentation on each of those individuals. Where the applicant is applying for an AIF, EU passporting has greatly aided this process, as Malta-licensed fund managers are able to market their services to professional investors across the EU as a whole. This is a significant advantage afforded to investors.

From the regulatory compliance perspective, VC investors and start-ups are obliged to comply with certain requirements. It is imperative, to this end, that efficient AML procedures are put in place and that reporting obligations are adhered to.

Moreover, Malta has been at the forefront of the introduction of new legislative instruments, such as the Notified AIF framework. This facilitates the process of launching AIFs which specifically target professional investors, even where they do not hold an MFSA licence. Under this framework, the MFSA is notified of such fund by means of an existing AIFM.

The MFSA's perspective and approach, while strict, is known to be prudent, in an effort to encourage fund structures with innovative ideas and help them flourish, but also ensure that compliance is attained and that investors are adequately protected. Another development of note is the update to the Investment Services Rulebook, with rules on marketing and management of VC funds. One of the more important changes implemented by the said amendments is the aligning of local legislation with the EU's Cross-Border Distribution of Funds Directive on procedures relating to pre-marketing.

There are several advantages offered by the legal and fiscal regimes in Malta. As mentioned previously, the corporate law framework in Malta aims to be business-friendly and efficient, allowing the fast incorporation of corporate structures and offering a variety of corporate forms suitable for start-ups (with the most popular being private limited liability companies). Tying in with this, regulatory and AML compliance regulations follow the EU model, and start-ups may benefit from various sandbox regimes offered by the MFSA and the MDIA, especially in the realms of fintech and similar. This affords businesses the opportunity to put their projects to the test, while under oversight from the MFSA. From a purely fiscal point of view, Malta does not levy capital gains tax on sales of shares when carried out by non-residents, provided, however, that certain conditions are satisfied. This is advantageous for foreign investors.

Moreover, fund vehicles are typically structured in a tax-neutral manner. For instance, it is customary for a limited partnership to be treated in a transparent manner for the purposes of taxation. More so, SiCAV (*Société d'Investissement à Capital Variable*) funds are often granted tax-exempt status on both their income and gains, with distributions being taxed at the level of

investors. This is applicable if the fund has less than 85% of its total declared assets in Malta.

Another notable scheme is the Seed Investment Scheme (SiS), which is mainly targeted at angel investors in the process of investing in start-ups. Under the SiS, an individual investor who purchases equity in a Maltese start-up can receive a 35% tax credit on their investment, provided that they are a resident in Malta. The total tax credit can be up to EUR250,000 a year. Each start-up can raise up to EUR750,000 solely through SiS investments. This scheme, which is fairly recent, helps to reduce income tax levied on investors by a substantial portion of their start-up investment, which effectively encourages high-net worth individuals to support start-ups in the early stages of their operations. It also give the entrepreneur the opportunity to tap into risk-tolerant capital, since angel investment would become more attractive and feasible.

While SiS is one of the main incentives in this regard, the Malta Enterprise also offers a myriad of tax credits and grants to aid start-ups. These include:

- R&D tax credits;
- innovation vouchers; and
- tax rebates on wages and salaries of highly-skilled employees.

Moreover, start-ups partaking in research and innovation are able to access these incentives in an effort to either limit or offset certain costs which may arise. In addition, Malta's favourable tax regime effectively means that, due to its full imputation system and refund system, start-up entrepreneurs and investors are aided upon their exit. In this regard, foreign investors are levied a low tax rate on their dividends and/or capital gains.

Furthermore, the National Strategy on AI entails that, while AI-start-ups are not heavily regulated, the jurisdiction has shown itself to be in line with the EU AI Act, aiming to hone an environment which helps AI to develop rapidly.

The Corporate Tax Regime

Malta's corporate tax regime is ideal for foreign investors seeking to invest in Malta. The corporate tax rate in Malta is charged at a flat rate of 35%, but through a tax refund mechanism, non-resident shareholders can apply for a significant tax refund, which often amounts to 30%, hence leading to an effective tax rate of only 5%.

The quantum of the refund depends on the accounting treatment of the income of the company, and, based on which, a tax refund is provided. Under Maltese law, there are 5 different tax accounts under which income can be allocated:

- the Final Tax Account;
- the Immovable Property Account;
- the Foreign Income Account;
- the Malta Taxed Account; and
- the Untaxed Account.

Based on where the profits of the company are allocated in the respective tax account, the shareholders of the company can claim significant refunds on their payable taxes. The refund mechanism is split into three different kinds, as set out below.

- 5/7 refund: this tax refund is available on taxes paid on profits deriving from passive interest or royalties. Passive income is considered passive when it is not directly or indirectly derived from active trading activity.
- 2/3 refund: this tax refund is available on taxes paid on profits on which double taxa-

tion relief has been claimed. There are various kinds of double taxation relief that can be obtained, and if any one of them is applied, this refund shall be applicable on such profits.
- 6/7 refund: this tax refund is available on taxes on profits arising from profits allocated to the Malta Taxed Account and the Foreign Income Account. This would include the vast majority of profits.

In most cases, a foreign-owned entity would be able to claim the maximum tax refund of 6/7ths, effectively reducing the tax payable by the company on its distributable profits to 5%. It is critical to note that the tax refund is granted to the direct shareholder of the company for whom the refund is applied; hence, it is not the company claiming the refund that would receive the refund payment, but its direct shareholder. In addition, Malta applies the full imputation system whereby the law prevents double taxation of the same income in the hands of the company and again in the hands of the shareholders. Hence, after the applicable tax has been levied on the trading company, no further tax is payable on the dividends received by the shareholders.

Recently, the legislator also introduced laws that allowed group entities qualifying under the rules to register as a single fiscal unit, which allows for tax consolidation between group entities. The practical effect of this law allows groups that register under the law to simply pay the final effective tax rate applicable, rather than apply for the tax refund. This provides a very significant cash flow boost for groups that qualify under the scheme, as the tax refund specified previously may take several months to be paid to the shareholders.

In addition to the tax refund system, Malta allows for the Participation Exemption, which originates from the Parent Subsidiary Directive. This Directive applies a tax exemption between participating holdings and their participating subsidiaries in EU member states. When the applicable criteria are satisfied for the exemption to apply, a full tax exemption applies on all taxes between the participating holding and its subsidiary.

The corporate tax system in Malta is critical to the VC sector in Malta. Most VC investors do not invest through a fund but invest directly in the company, either personally or through their own corporate group, to benefit directly from the corporate tax system.

Possibilities for the Future

In light of the above, Malta's flexible regulatory and fiscal regimes combine EU oversight with attractive fiscal incentives. The framework allows investors to benefit from these regimes, with start-ups benefitting from sound governance and investor trust.

Trust in solid policies and legal protections (in the context of shareholder rights and contract enforcement) is crucial, especially for VC. Investor rights have so far been protected by Malta's legal system, which is based on EU law. However, any political unrest or changes in policy could be dangerous. Furthermore, Malta's tax advantage could be undermined by impending international tax changes (such the OECD global minimum tax), which could make it less appealing to holding firms or funds.

Malta must carefully manage these adjustments to maintain its competitive advantage without sacrificing compliance.

The lack of later-stage funding is a problem from the standpoint of entrepreneurs. Angel investors and government matching programmes

have made it simpler to secure seed money, but Maltese start-ups frequently need to approach international venture capitalists in order to grow. By being closer to investors and customers, this may result in promising businesses moving their headquarters to bigger markets or even moving important activities overseas. Malta runs the danger of losing out on the talent and economic advantages when that occurs. The ecosystem is also hampered by low visibility: a lot of investment agreements in Malta go unreported (founders frequently do not disclose funding rounds), which means that success stories do not always receive the recognition they require to motivate others. The story of Malta as a developing hub may be hampered by the absence of publicly available investment data, which could make it more difficult to attract new entrepreneurs or investors.

Lastly, there are drawbacks to relying too much on public sector assistance. The VC industry has been stimulated by government initiatives, although having the state as a key investment source carries some risk. Compared to private venture capitalists, public funds might make decisions more slowly and with different motivations.

Malta's state venture fund must attract private investment rather than drive it away. The ability of such plans to show returns and professionalism will determine their success in persuading private investors to co-invest instead of assuming the government will handle all initial funding. If this is not done correctly, there is a chance that start-ups will become reliant on government assistance and find it difficult to switch to completely commercial funding sources.

In conclusion, Malta's modest market, talent and capital scale, as well as the growing pains of a young ecosystem, are the main risks and obstacles facing VC in the island. Talent shortages, cultural risk aversion, a lack of local capital throughout growth stages, and external variables like tax changes and regulatory compliance are some of the main problems.

In future years, there will probably be a greater emphasis on developing industries. Malta-based fintechs now have the chance to compete throughout Europe thanks to EU-wide efforts like the Digital Finance Package and open banking legislation. If they are successful, they will attract more VC funding. Malta may be considered a compliance-friendly jurisdiction for the development of AI products because of its dedication to AI and its implementation of the EU AI Act once it becomes operative, which could attract AI start-ups from less regulated areas. Now that the wild west of cryptocurrency exchanges has subsided, the blockchain industry is likely to change its focus, possibly concentrating on institutional and enterprise DLT solutions. If trends like asset tokenisation and decentralised infrastructure persist, with businesses like PEAQ setting the standard, Malta's early investment in blockchain technology may render successful. A successful game studio exit or a well-attended e-sports league in Malta might lead to a small cluster of gaming start-ups backed by specialised investors, making e-sports and gaming another potentially recognisable vertical for the country.

With the advent of new innovation programmes and incubators (sometimes in collaboration with universities), the future of education seems bright. The facilities required for start-ups to flourish will be provided by infrastructure initiatives such as the extension of co-working spaces and innovation hubs (for instance, the proposed addition of new tech labs to the Malta Life Sciences Park). In the event that Malta continues to

nurture and give innovation the required platform to grow, the VC market in Malta is set for continued growth. A thriving VC market would reap the benefits of attracting more investors and entrepreneurs, validating Malta as a destination for significant results, and encouraging local capital to get more involved.

MEXICO

Law and Practice

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Ritch Mueller is a top-tier multidisciplinary transactional firm committed to offering high value-added legal advice to national and international clients in the structuring, development and financing of their private businesses and public sector projects in Mexico. Ritch Mueller's work encompasses transactions within the financial, industrial, infrastructure, energy, retail and services sectors, among others. The firm is staffed by more than 100 professionals who seek to provide added value to clients by means of an efficient and in-depth service combined with high levels of expertise and experience.

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1. Trends

1.1 VC Market

The most sizeable/landmark venture capital-related transactions during the past 12 months include the following:

- QED Investors led a USD25 million Series A+ for Zubale, a Mexican fulfilment services marketplace connecting independent contractors with retailers;
- Third Prime led a USD6.5 million round for Finerio Connect, a Mexican fintech offering businesses an Application Programming Interface (API) for enterprise account management, with participation from Alaya Capital, Visa and Bancolombia Ventures;
- NAZCA and IDB Invest led a USD15.5 million Series A for Wonder Brands, a Mexico- and Argentina-based e-commerce aggregator looking to acquire independent brands selling on platforms such as Amazon and Mercado Libre, with participation from CoVenture, SilverCircle, Korify Capital, Infinitas Capital and GBM Mexico;
- Mexico-based personal finance management and lending platform Klar secured a USD100 million credit line from Victory Park Capital;
- Dalus Capital and Foundation Capital led a USD10 million seed round for Clivi, a Mexican diabetes healthcare delivery platform, with participation from FEMSA Ventures, Cathay Innovation, Quiet Capital, 500 Global, Next Billion Ventures and Conexo;
- IDB Invest provided a USD15 million structured loan to Habi, a Colombian residential real estate platform, to launch operations in Mexico;
- Community Investment Management provided a USD50 million credit line to Stori, a Mexico-based credit card issuer for the underbanked;
- Niya Partners and Tribe Capital led a USD20 million Series A for Kapital, a Mexican finance management platform for SMEs, with participation from Broom Ventures, FoundersX, True Capital Management, Pioneer Fund, Kube VC, MyAsia VC and angel Arash Ferdowshi (Dropbox);
- Mexico-based embedded lending infrastructure company R2 closed a USD100 million warehouse facility from Community Investment Management;
- L Catterton made an undisclosed follow-on investment in Ben & Frank, a Mexico-based D2C eyewear brand; and

- GGV led a USD60 million Series B+ for Clara, a Mexican corporate expense management platform, with participation from Endeavor Catalyst, Citi Ventures, Acrew Capital, Ethos, Commerce Ventures, Goanna Capital, Bayhouse Capital and Fluente Ventures, and follow-on from Monashees, Coatue and others.

1.2 Key Trends

In 2025, the venture capital ecosystem in Mexico is poised to enter an exciting new phase, with expectations of increased dynamism and a broader range of investment opportunities. During the next few years, the country's start-up ecosystem is anticipated to grow in both size and sophistication, driven by a combination of entrepreneurial spirit, technological innovation, and favourable macroeconomic conditions.

1.3 Key Industries

In 2025, several sectors in Mexico will see significant benefits from the influx of venture capital investments. The most notable sectors include AI, fintech, healthtech and wellness, renewable energy, and sustainability. Also, agrotech and cleantech are demonstrating their ability to address structural challenges. These emerging industries are attracting venture capital investors in Mexico who seek to have a significant impact on global issues while generating attractive returns.

2. Venture Capital Funds

2.1 Fund Structure

Venture capital funds are typically organised as trusts or *asociaciones de participación*, which are the two Mexican vehicles that are deemed transparent for tax purposes. Venture capital funds typically have a general partner or manager that makes all or most of the decisions. The corporate documentation that will govern the affairs of the fund is the trust agreement or the *asociación en participación* agreement, together with the professional services agreement with the manager of the fund.

Decisions are typically adopted by the manager or general partner, and by an investment committee. In some cases, certain major key decisions need to be approved by a majority or special majority of investors.

2.2 Fund Economics

Venture capital principals typically assist by identifying investment opportunities for the fund, conducting due diligence on target companies, helping to manage portfolio companies, and performing a variety of other duties. In exchange, they are entitled to receive a management fee and a carried interest. They also generally co-invest in the fund, with other investors. As in other jurisdictions, venture capital funds in Mexico typically include customary investor protections, such as key man provisions, manager removal events, dedication of time by key managers, conflict of interest provisions, and non-compete and non-solicitation clauses.

2.3 Fund Regulation

Venture capital funds are not regulated in Mexico.

2.4 Particularities

The venture capital ecosystem has accelerated in Mexico in recent years, especially in 2021 when venture capital investment boomed. Venture capital fund investments are generally made in start-ups and SMEs, which are important engines of employment creation and economic growth. There are certain impact funds whose investment thesis opportunity is to drive

a positive social, technological and environmental impact upon its investments, whereas funds-of-funds hold the dual mandate of generating attractive risk-adjusted returns while promoting the private equity ecosystem in Mexico. As of October 2024, Mexico was home to nine unicorns (Kavak, Bitso, Clip, Confio, Merama, Incode, Clara, Nowports and Stori), with Plata joining the ranks as the tenth unicorn in March 2025. The growing number of high-value start-ups signals a shift in the Mexican economy, positioning the country as a rising player in the global venture capital ecosystem.

3. Investments in Venture Capital Portfolio Companies

3.1 Due Diligence

In-depth due diligence usually focuses on corporate, material contracts, IP, employment matters, tax, litigation, and regulatory matters. Generally, counsel is asked to provide a report on red flags only, limited to identifying material contingencies of the target.

3.2 Process

A new financing round would generally take between one and two months as of the date legal and tax due diligence begins. Negotiations of the term sheet and commercial due diligence are carried out before legal and tax due diligence begins, and the investment agreements are negotiated while the legal and tax due diligence is being carried out. Venture capital counsel will take the lead in preparing the investment agreements; if more than one venture capital fund is participating in the financing round, the leading venture capital fund will take the lead in negotiating the agreements, but all of the venture capital funds participating in the financing round will have to agree upon the agreements.

3.3 Investment Structure

Preferred shares grant the corresponding shareholder preferred rights, which may include preferred dividends, a certain number of board seats, anti-dilution protections, and a liquidity or liquidation preference. A complementary or alternative structure is venture debt, which is expected to grow during 2025, providing flexible capital structures less dilutive to founders.

3.4 Documentation

The typical key documents comprising a financing round in a growth company in Mexico are a subscription agreement and a shareholders' agreement (which are incorporated into the by-laws of the company), together with the ancillary documents related thereto, such as shareholder resolutions and other closing corporate documents. Simple agreements for future equity (SAFEs) are commonly used in the USA but lack certain terms and conditions, which may prevent investors subscribing and paying for the corresponding shares.

As opposed to the USA, where existing templates from the National Venture Capital Association are available, there are no templates that the market relies upon in Mexico. However, there are certain US practices that have been taken into consideration and imported and tailored to Mexico.

3.5 Investor Safeguards

Venture capital investors are typically able to include weighted average (as opposed to full ratchet) anti-dilution provisions, liquidation preference provisions and pre-emptive rights for the subscription of new shares. Anti-dilution and liquidation preference provisions are generally effective for a certain period of time. Pre-emptive rights are typically granted to all investors, including founders, but excluding employees.

3.6 Corporate Governance

Venture capital investors typically have the right to appoint a board member and the right to call shareholders' meetings. They do not generally have veto rights, unless they hold approximately 15% or more of the voting shares. Venture capital investors typically do not have drag-along or similar liquidity rights, unless they hold approximately 50% or more of the voting shares. Redemption rights (or similar put rights against the company) are not typically granted to venture capital investors.

3.7 Contractual Protection

Customary representations and warranties include fundamental representations (ownership of shares, due organisation, capacity, and legal authority), operational representations related to the company's business, tax representations, and AML, anti-corruption and data privacy laws. Covenants are related to interim operating provisions that affect or restrict how the company operates from the date of the agreement and until closing – ie, operating in the ordinary course of business. Post-closing, founders are also bound by non-compete provisions, and investors have access to financial information, among other things.

Indemnity provisions are limited to fraud or wilful misconduct.

4. Government Inducements

4.1 Subsidy Programmes

There are no government/quasi-government programmes to incentivise (equity) financings in growth companies in Mexico.

4.2 Tax Treatment

Mexican Tax Treatment

There are no particular tax incentives geared towards investment in growth/start-up/venture capital fund portfolio companies, so all these Mexican entities receive the same tax treatment as any other Mexican resident entity. They are required to determine their Mexican income tax on an annual basis, applying a flat 30% corporate income tax rate to their *"taxable result"*, which is determined by subtracting the following from their annual gross taxable income:

- authorised deductions;
- the employees' profit-sharing amount paid in the corresponding fiscal year; and
- the net operating losses (NOLs) from previous years.

Implications for Non-Mexican Investors Investing in Growth/Start-Ups/Venture Capital Funds in Mexico

Pursuant to Mexican tax provisions, Mexican-source income earned by non-Mexican residents is generally subject to Mexican withholding tax. Capital gains derived from the transfer of shares are considered to be from a Mexican source if the issuer of the shares is a Mexican resident entity or if more than 50% of the accounting value of the shares is represented, directly or indirectly, by immovable property located in Mexico.

As a general rule, transfers of Mexican shares by non-Mexican residents are subject to tax at a rate of 25% on the gross proceeds of the transaction (ie, sale price, fair market value), without any deduction. Alternatively, upon election by the seller, the transfer of shares may be subject to tax on the net gain. Under this election, the gain (if any) realised upon the transfer of Mexican shares should be subject to a 35% tax rate, before consideration of applicable treaty rates,

to the extent that certain requirements are met, including appointing a legal representative in Mexico. In addition, non-Mexican residents may be subject to a 10% withholding tax when the entity distributes dividends. The 10% tax rate can be reduced by claiming the benefits of a tax treaty.

Tax Treatment for Common Investment Structures

There is a growing trend of investing in Mexican growth/start-ups/venture capital fund portfolio companies using Cayman Islands entities or US limited liability companies (LLCs) that are not subject to US taxes. In principle, this investment structure seems to be tax-efficient, given that only the direct transfer of shares issued by Mexican-resident entities or the indirect transfer of shares in Mexican land-rich assets are subject to taxes in Mexico. This trend has led to increased transfers of Mexican investments, assuming that there will be no capital gains taxes if investors sell the Cayman Islands entity or the US LLC.

However, Mexican tax residency is determined based on factors such as the main place of business administration or effective management, rather than merely the location of incorporation. Under these structures, many holding companies – where operations and management remain in Mexico – are likely to be considered Mexican tax residents, making the sale of their shares subject to Mexican income tax.

Implications for Mexican Investors

Mexican residents (entities and individuals) are subject to income tax on income from worldwide sources. Consequently, Mexican entities are taxed in Mexico at a rate of 30% on income earned from this type of investment (except for dividends distributed by Mexican legal entities, which qualify as non-taxable income), and Mexican individuals are subject to a progressive tax rate of up to 35%. Mexican individuals who receive dividends from non-Mexican resident companies should be subject to an additional 10% tax rate.

4.3 Government Endorsement

A systematic issue for venture capital funds in Mexico is identifying exit strategies that maximise the value of their investments. Mexico's securities market is a natural exit strategy for many investors, such as venture capital funds, but is relatively illiquid and has shrunk during the past few years. In December 2023, a series of structural amendments to the Mexican Securities Market Law, supported by Mexico, were enacted to:

- incorporate a new simplified procedure for the registration of securities in the Mexican National Securities Registry; and
- make amendments to the issuers' corporate regime aimed at revitalising the Mexican securities market, including the removal of the ceiling for non-voting stock.

5. Employment Incentives

5.1 General

Long-term commitment is often sought by offering equity (or equity-linked incentives) to employees, which provides them with a sense of ownership and aligns the incentives for employees with those for equity holders.

5.2 Securities

Incentive plans are typically structured as stock options, phantom shares, performance bonuses or profit-sharing mechanisms. In Mexico, companies tend to prefer to grant stock options, which are typically the most burdensome to implement.

Employee Stock Ownership Plan shares are typically kept in the treasury of the company and are given (assigned) to the employees for subscription and payment upon certain conditions provided for in their employment agreements being met. Such shares are typically non-voting shares and are subject to special transfer provisions. These incentives usually create corporate, labour and tax concerns, and should be structured carefully.

5.3 Taxation of Instruments

The tax considerations that determine the structure of an incentive pool are diverse. Firstly, it is important to consider the type of incentive offered – ie, whether it is in the form of stock options, phantom shares, performance bonuses or profit sharing, among others. Each of these incentives may have different tax implications for both the company and the beneficiaries.

Secondly, it is relevant to consider the applicable tax treatment for each type of income or benefit. By way of example, stock options may be subject to tax at the time of subscription of the shares, whereas phantom shares or performance bonuses may be taxed at the time of payment of the economic benefits.

In addition, the applicable tax rate may vary depending on the type and amount of income. However, most such benefits (when paid either in cash or in shares) are deemed salary payments for Mexican tax purposes.

In summary, when structuring an incentive pool, it is crucial to consider not only the type of incentive offered but also the tax implications for both the company and the beneficiaries, including the applicable tax rate and the timing of taxable events.

5.4 Implementation

How the implementation of an investment round and the set-up/installation of an employee incentive programme typically inter-relate depends on whether stock options have vested or not, and whether the investment of such stock options may dilute the share participation of the investor as a result. Owing to the formalities involved in issuing new shares in Mexico, determining the number of shares that would correspond to the investor can be a complex issue.

6. Exits

6.1 Investor Exit Rights

The exit-related provisions that typically govern the shareholders' rights among one another in relation to a sale or IPO of the venture or another liquidity event include a right of first offer, a tag-along right and a drag-along right, as well as piggyback and registration rights. A right of first offer provision is often included to give certain major venture capital investors the first option to purchase the shares of the company in a potential sale before they are offered to other third parties. A tag-along right is granted to the venture capital investors for any transfer by a key holder for which the rights of first offer are not exercised. A drag-along right is typically granted to shareholders representing more than 50% of the share ownership, who will then generally be able to force the other shareholders to co-sell their shares to a prospective buyer who wishes to acquire the entire company. Documentation may also include lock-ups (especially for founders, for a certain period of time) and customary exemptions thereto for permitted transfers.

The decision of which exit strategy to pursue is typically made by the company's board of directors, with input from the company's manage-

ment team and advisers. The decision is based on a number of factors, including the stage of the company's development, the market conditions at the time, and the preferences of the shareholders.

6.2 IPO Exits

Mexico's securities market is relatively illiquid. The lack of penetration of financial services in the general population, coupled with a limited number of institutional and qualified investors, low valuations and significant delays in the review process by Mexican regulators, has relegated the Mexican securities market as a viable exit strategy or even an attractive alternative for venture capital funds. No primary IPOs from Mexican issuers have taken place since 2020, and the most recent IPO by a Mexican company was registered in the USA exclusively, not in Mexico.

6.3 Pre-IPO Liquidity

There is very limited liquidity and the few options would be among venture capital funds or private equity funds that have begun to do venture capital investments and are looking to obtain control. Although it is not very common, employees sometimes have the option to participate in buybacks. The main challenge is that all distributions, including buybacks, are made pro rata; if there is the intention to distribute them non-pro rata, different series of shares would need to be created so that such non-pro rata distributions are a special right of a particular series.

7. Regulation

7.1 Securities Offerings

Any public offering of securities in Mexico requires the prior registration of the securities with the National Securities Registry maintained by the Mexican Banking and Securities Commission (*Comision Nacional Bancaria y de Valores*, or CNBV). However, the recently enacted reform to the Mexican Securities Market Law enables a company to conduct a public offer pursuant to an expedited process, known as a simplified registration process – in which case, the CNBV's review and approval are not required. However, only institutional and qualified investors are entitled to purchase stock issued pursuant to a simplified registration process, which may limit the liquidity. Both traditional and simplified registration processes require the preparation of a prospectus or supplement and filing for registration with the CNBV or the corresponding Mexican stock exchange, respectively.

7.2 Restrictions

Foreign (and national) venture capital investors may be restricted from investing in certain sectors of the Mexican economy, which are regulated. There may be foreign investment restrictions, as is the case in transportation, mining and telecommunications, and/or the need to obtain prior approval to invest, as is the case in insurance companies, fintech or banking. Depending on the sector in which the target company operates, applicable restrictions may apply.

Trends and Developments

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Ritch Mueller

Ritch Mueller is a top-tier multidisciplinary transactional firm committed to offering high value-added legal advice to national and international clients in the structuring, development and financing of their private businesses and public sector projects in Mexico. Ritch Mueller's work encompasses transactions within the financial, industrial, infrastructure, energy, retail and services sectors, among others. The firm is staffed by more than 100 professionals who seek to provide added value to clients by means of an efficient and in-depth service combined with high levels of expertise and experience.

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How Mexico's Booming Start-Up Scene Is Shaping Its Venture Capital Landscape

The future of Mexican venture capital looks incredibly promising, given that – as a country – Mexico has firmly established itself as a leading destination for venture capital funds in Latin America, defined by a dynamic and rapidly evolving start-up ecosystem, a thriving fintech sector, and a favourable regulatory framework that encourages investment. Mexico's robust entrepreneurial landscape and lifestyle have attracted a growing number of venture capital funds keen to capitalise on the opportunities presented by a diverse and emerging market. As Mexico's start-up scene grows and matures, it continues to draw attention from local and international investors alike who are eager to tap into Mexico's innovation potential.

The number of venture capital funds operating in Mexico has been steadily increasing as more start-ups secure funding and scale their operations. According to the Mexican Association of Private Equity (*Asociación Mexicana de Capital Privado*, or *"AMEXCAP"*), 581 start-ups operating in Mexico have benefited from venture capital support. Notably, 455 of these start-ups are still operational five years after their launch, thereby evidencing a strong survival rate of 78%. Such an impressive survival rate underscores the resilience of Mexican start-ups and their ability to flourish in a competitive market, even in the face of economic and political challenges.

AMEXCAP reports that, in 2024, venture capital investments allocated over USD900 million specifically for Mexico – representing not only an important increase but also a significant recovery compared to previous years. This surge both in transactions and the size thereof reinforces a renewed confidence in Mexico's entrepreneurial landscape and its potential to generate high-impact businesses.

Furthermore, TTR Data – a leading provider of information on M&A, venture capital and private equity transactions across Latin America – reports that the total value of venture capital investments in Mexico saw an impressive 59.38% growth in 2024 compared to 2023, which is a clear indicator of the increasing trust investors have in Mexico's innovative sectors, such as AI, fintech, healthtech and wellness, renewable energy and sustainability. The expansion of venture capital funds in Mexico focuses its emerging role as a central investment hub in Latin America. One of the key drivers of this expansion is the favourable regulatory environment that the Mexican government has created to support venture capital investments. Policies and regulations have been implemented to encourage the formation of venture capital funds and to provide tax incentives for investors. These measures have made it easier for venture capital funds to operate in Mexico. The influx of investment not only strengthens the Mexican economy but also accelerates the development of new technologies and industries, driving long-term innovation and sustainable growth both within Mexico and on a global scale.

2025 is set to be a crucial year for the consolidation of venture capital funds in Mexico, as more and more start-ups are reaching the scale necessary to attract larger investors, positioning themselves to generate significant economic value and consequently increasing the volume of transactions.

According to data collected by Endeavor, a renowned global network of entrepreneurs and investors, Mexico has the potential to create 30 unicorns valued at over USD1 billion by

2025. The foregoing would represent a dramatic increase from the current number of unicorns in Mexico. As of October 2024, Mexico was home to nine unicorns (Kavak, Bitso, Clip, Confio, Merama, Incode, Clara, Nowports and Stori), while Plata joined the ranks as the tenth unicorn in March of 2025. The growing number of high-value start-ups signals a shift in the Mexican economy, positioning the country as a rising player in the global venture capital ecosystem.

Despite the growing number of unicorns, Mexico finds itself at a critical juncture in its pursuit of becoming a global leader in the venture capital ecosystem. Although obstacles such as limited access to capital, regulatory hurdles, and talent acquisition remain significant challenges, Mexico also faces tremendous opportunities, which include a rapidly expanding market, increasing government support and technological advancements. By tackling these challenges head-on and capitalising on its emerging opportunities, Mexico has the potential to further foster greater economic growth and drive innovation across the globe.

In 2025, several sectors in Mexico will see significant benefits from the influx of venture capital investments. The most notable sectors are discussed here.

AI

AI is leading a revolution in the world and the venture capital ecosystem is not estranged to it. The handling and use of AI – as well as the ability to maximise it – have become the main challenges for 2025, but also the main target for venture capital funds. Endeavor reports that in 2024 AI accounted for 34% of the investment rounds closed in Latin America, showing an increasing interest in technologies such as chatbots, adaptive AI, and start-ups with in-house AI development. The increase in such percentage for 2025 is just a matter of time, as technology continues to develop and the solutions it provides are becoming paramount for all industries. This focus not only responds to a need for innovation but also to the growing competitiveness in global markets, where Mexican start-ups are gaining relevance.

The rapid advancements in AI are transforming various sectors, by providing more efficient, accurate and scalable solutions. Investors are particularly drawn to AI's potential to disrupt traditional business models and create new market opportunities. As AI continues to evolve, it is expected to play a crucial role in propelling the venture capital development and technological expansion in Mexico.

Fintech

The fintech sector has proven to be an essential support in the venture capital ecosystem in Latin America, consolidating as one of the safest and most strategic bets for investors. As reported by Endeavor, in the first half of 2024, the fintech sector captured 37% of the total amount of investment in Latin America – highlighting the return of start-ups that achieved important milestones and seek to continue their expansion. The flexibility and adaptability of fintech companies have been key factors in their recovery. These start-ups are leveraging advanced technologies such as blockchain, AI and machine learning to deliver innovative financial services that meet the evolving needs of consumers and businesses alike. The fintech sector's ability to provide inclusive financial solutions, particularly in underserved markets, has further solidified its position as a vital driver of economic progress in Mexico.

Healthtech and wellness

The healthtech sector remains a top priority for venture capital investors in Mexico, with start-ups harnessing the power of AI and big data to revolutionise healthcare, telemedicine, and biotechnology. From predictive analytics to personalised treatments, these companies are reshaping the way healthcare services are delivered and accessed across the region, including exclusively through mobile apps. AI in healthtech is enhancing diagnostic accuracy, streamlining treatment plans and improving patient outcomes.

Additionally, the integration of big data is facilitating better decision-making and resource allocation in healthcare systems. Likewise, wellness continues to consolidate as a key industry. The innovative proposals in this sector address integral well-being, from mental health to personalised fitness, creating a diversified offer that is attracting the interest of consumers and investors alike. The growing awareness of the importance of mental and physical health is driving demand for wellness solutions, making this a lucrative market for start-ups and established companies.

Renewable energy and sustainability

The renewable energy and sustainability sector will gain ground as one of the main priorities for venture capital investors in Latin America. The growing need for decarbonisation to meet global sustainability goals has boosted the interest in clean technologies such as green hydrogen, renewable energy generation, and energy efficiency solutions. These investments not only seek to respond to climate challenges but also to take advantage of the potential of the region as a leader in natural resources and innovation capacity.

In addition, digitalisation and the development of data centres are generating an exponential demand for clean energy. This context opens opportunities for start-ups and established companies to lead projects that transform the energy matrix of the region and promote sustainable economic growth. The renewable energy sector is also benefiting from supportive government policies and international collaborations aimed at reducing carbon emissions and promoting sustainable practices. In Mexico, the private sector has been permitted to generate electricity and sell it in a wholesale electricity market for more than a decade – during which time, the installed capacity of renewable energy has been doubled, as reported by the International Renewable Energy Agency in 2024.

In March 2025, various reforms were enacted in the sector that continue to promote a more socially and environmentally responsible energy sector in Mexico, while also recognising the State's prevalence in the sector through the state-owned public companies (ie, Pemex and CFE). Industry participants are still awaiting the impact of these reforms on national energy policies and the broader energy sector. However, sustainable growth in the coming years is anticipated due to Mexico's ongoing need for infrastructure to satisfy its population's needs and fulfil international commitments.

Finally, agrotech and cleantech are demonstrating their ability to address structural challenges. These emerging industries are attracting venture capital investors in Mexico who seek to have a significant ameliorative impact on global problems while generating attractive returns.

Outlook

As of 2025, the venture capital ecosystem in Mexico is poised to enter an exciting new phase,

with expectations of increased dynamism and a broader range of investment opportunities. During the next few years, the country's start-up ecosystem is anticipated to grow both in size and sophistication, driven by a combination of entrepreneurial spirit, technological innovation, and favourable macroeconomic conditions.

As more start-ups reach the scale-up phase, the country's venture capital scene is expected to become more vibrant, with a diverse array of sectors receiving attention. Venture debt is also expected to grow as a complementary or alternative financing tool.

NETHERLANDS

Law and Practice

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1. Trends

1.1 VC Market

General Development of the Dutch Venture Capital Industry

After reaching a peak in 2021, venture capital (VC) investments in the Netherlands somewhat slowed down in 2022 and 2023. Although VC investments in the Netherlands in 2024 amounted to approximately EUR2 billion, making them comparable to the year before, the investment levels remain lower than those in the peak year 2021. This is consistent with the global trend, where VC investments are down, mainly driven by high interest rates and the slacking IPO and exit environment.

However, 2024 was a record-breaking year for Dutch venture capital fundraising. New VC funds raised over EUR3 billion in aggregate, which is mainly due to the incorporation of certain larger funds such as Forbion's Growth Opportunities Fund III, Innovation Industries Fund III and Forbion Ventures Fund VII.

The uncertainty stemming from rising trade tariffs and geopolitical tensions is expected to also affect the Dutch VC industry. However, the authors expect the Dutch VC market will continue to be active, especially given the declining interest rates (with the ECB lowering interest to 2.25% in April 2025), the steady level of dry powder in the Dutch VC market and the Dutch government's increased sense of urgency about becoming less dependent on foreign countries and investing more in defence, dual-use technologies and deep tech.

See the Dutch Trends and Developments chapter in this guide for an overview of the most noteworthy VC transactions in the Dutch VC market in 2024 and Q1 2025.

Unless explicitly referred to a later date, the cut-off date for this article was 1 April 2025. In this chapter of the guide, both growth investments and venture capital investments are referred to as VC investments. Unless otherwise indicated, the statistics in this chapter of the guide are from the Dutch Association for Participation Companies (Nederlandse Vereniging voor Participatiemaatschappijen or NVP), as made available prior to 6 May 2025.

1.2 Key Trends

See the Dutch Trends and Developments chapter in this guide.

1.3 Key Industries

See the Dutch Trends and Developments chapter in this guide.

2. Venture Capital Funds

2.1 Fund Structure

Fund Structure

The most common legal forms used by Dutch VC funds are the Dutch co-operative with excluded liability (*coöperatie, UA*) and the Dutch limited partnership (*commanditaire vennootschap*).

Co-operative

A co-operative is a special type of association, and, as a legal entity, can hold the legal title to the fund's assets. The co-operative does not have capital divided into shares. Instead, the investors participate in the co-operative as members holding membership rights. Each investor would generally be entitled to a pro rata part of the co-operative's profits, though there is considerable flexibility in the allocation of profits.

Limited partnership

A limited partnership is a contractual arrangement between the investors (as limited partners) and the VC fund manager (as general partner). The limited partnership itself is not a legal entity, and thus cannot hold the legal title to the assets of the VC fund. The VC fund's assets are therefore either held by the general partner or by a foundation specifically established for that purpose, which holds assets for the risk and account of the investors.

Until 2025, the classification of a limited partnership as opaque or as tax-transparent was determined on the basis of the so-called *"consent requirement"*, pursuant to which a limited partnership was (only) treated as tax-transparent if the admission and substitution of partners required the prior consent of all (limited and general) partners. If that was not the case, the limited partnership was classified as opaque. As of 1 January 2025, new Dutch entity classification rules apply pursuant to which a limited partnership is, in principle, by default treated as tax-transparent for Dutch tax purposes (see **4.2 Tax Treatment** for a discussion of the consequences thereof). In certain situations a limited partnership may, however, still be treated as opaque for Dutch tax purposes (despite the default classification as tax-transparent), but for VC funds taking the form of a limited partnership these situations are generally less likely to apply.

The private limited liability company (*besloten vennootschap*) is also used by VC funds, though less frequently.

Main Benefits of a Co-Operative and Tax-Transparent Limited Partnership

The main benefits to using a co-operative or tax-transparent limited partnership are that such legal forms provide for great flexibility in terms of creating tailor-made fund arrangements (mainly because a co-operative and a limited partnership are not subject to the various strict, mandatory Dutch corporate law provisions). If properly structured, they provide for *"tax-neutral"* fund entity, in the sense that they generally do not create an additional layer of Dutch taxation between the investors in the VC fund and the underlying portfolio companies.

A private limited liability company can also be a suitable fund entity from a Dutch tax perspective, but in certain circumstances may (compared to a co-operative) create a potential layer of Dutch taxation between (part of) the investors and the underlying portfolio investments (ie, in which case it would not produce a tax-neutral result).

Parties Involved and the Decision-Making Process

Regardless of the VC fund's legal form, organisation and governance will generally look similar in each VC fund. The investors in the fund will be the limited partners, members or shareholders of the fund, and the fund will be managed by the managers who organise themselves through a separate vehicle (that is, the manager of the fund). There is also the management company, which consists of the employees responsible for the allocation of capital and for managing investments.

The fund manager controls the VC fund, makes investment decisions and represents the fund, provided that detailed arrangements are included in the fund documentation to also give a certain level of control and oversight to the limited partners (eg, through reserved matters, though also by pre-agreeing to detailed investment guidelines).

Legal Documentation Needed for Setting Up the Fund

The documentation needed for the establishment of a VC fund typically consists of the following.

Fund agreement, members' agreement or limited partnership agreement (LPA)

This is the key agreement, setting out the terms and conditions of the VC fund.

Subscription agreement

The agreement pursuant to which the investors subscribe to the fund and oblige themselves to contribute capital.

Management or services agreement

The agreement between the fund manager/fund and the management company in relation to the fund, pursuant to which the managers commit to provide management services to the fund against the payment of a management fee (see also **2.2 Fund Economics** regarding the management fee).

Side letters

Larger investors in funds, in particular, may require additional investor rights, which are typically set out in *"side letters"*. Such rights may include additional approval rights, co-investment rights and *"most favoured nation"* clause.

Deed of incorporation

The notarial deed of incorporation, together with its articles of association, is required for a co-operative and for a private limited liability company, but not for a limited partnership, which can be established without the involvement of a Dutch civil law notary.

2.2 Fund Economics

The Management Fee

For managing the fund, the management company receives a management fee pursuant to a management or services agreement (see **2.1 Fund Structure**), which is used to pay certain costs incurred on its behalf (eg, personnel).

During the investment period (ie, the stage in the life of a VC fund where the fund manager invests the investors' capital), the management fee typically amounts to 1.5% to 2% of the committed capital per year. Following the investment period (ie, when the VC aims to exit its investments), the management fee generally amounts to such percentage of the unrealised investments (possibly subject to a step down).

Carried Interest

The fund managers participate in the fund's economics through so-called carried interest. Car-

ried interest refers to a share of profits that the fund manager receives as a performance fee, calculated as a percentage – typically around 20% – of the fund's profits after returning the investors' capital, increased with *"hurdle amount"*. This serves as an incentive for fund managers to generate positive returns for their investors. The hurdle amount is a minimum return that investors must receive, and is calculated as a percentage of the capital that investors have invested in the fund (eg, 6% to 8%). For a discussion of the Dutch tax regime applicable to carried interest (the so-called lucrative interest regime) and certain developments relating thereto, see **5.3 Taxation of Instruments**.

General Partner Commitment

To ensure that the fund managers also have *"skin in the game"*, and to create stronger alignment of interests between the fund managers and the investors, the fund managers are generally required to invest in the fund themselves on the same terms as the other investors (eg, 1% to 3% of the total committed capital).

Claw-Back Provisions in Fund Agreements

The final amounts to which the fund managers and the other investors are entitled can only be established after the fund has been dissolved and all investments have been disposed of. However, since proceeds will be distributed during the term of the fund, fund agreements will provide for so-called claw-back arrangements, which require the fund manager and each investor to restore funds to the fund, if and to the extent that it has received distributions in excess of the amounts it would have received if no distributions had been made until the dissolution of the fund.

2.3 Fund Regulation

Regulatory Aspects of VC Funds

A VC fund will, for regulatory purposes, typically qualify as an *"alternative investment fund"* (*alternatieve beleggingsinstelling*). This definition stems from the EU's Alternative Investment Fund Managers Directive (AIFMD) as implemented in the Netherlands by the Financial Supervision Act (*Wet op het financieel toezicht*, or Wft).

Managers of alternative investment funds (AIFMs) are regulated by the Netherlands Authority for the Financial Markets (AFM).

If an investment vehicle qualifies as an alternative investment fund, it falls within the scope of the AIFMD. Under the AIFMD, a licence requirement applies to an AIFM, but small AIFMs only require a registration in accordance with the de minimis exemption in the AIFMD (often referred to as the *"AIFMD-light regime"*).

There are two categories within the AIFMD-light regime. In each case, a registration with the AFM is required. Please note that, unlike for a fully fledged AIFM licence, the registration cannot be passported to other EU member states.

Offering exclusively to professional investors

If an AIFM offers units or shares in an alternative investment fund to professional investors, and manages (one or more) alternative investment funds whose total assets under management are less than or equal to EUR100 million or are less than or equal to EUR500 million (in the case of an AIFM managing alternative investment funds that do not use leverage and that are closed-ended for the first five years), the AIFM is exempt from the licensing regime but is required to register under the registration regime.

Offering to non-professional investors

Additional requirements apply if an AIFM offers units to non-professional investors exclusively, or to both professional and non-professional investors, and manages (one or more) alternative investment funds whose total assets under management:

- are less than or equal to EUR100 million; or
- are less than or equal to EUR500 million, in the case of a manager managing funds that do not use leverage and that are closed-ended for the first five years.

To fall under the registration regime, these managed units can only:

- be offered to fewer than 150 persons; and/or
- be acquired for an equivalent value of at least EUR100,000 per participant, or have a nominal value per right of at least EUR100,000.

If these requirements are met, the AIFM is exempt from the licensing regime but is required to register under the registration regime.

2.4 Particularities

See the Dutch Trends and Developments chapter in this guide.

3. Investments in Venture Capital Portfolio Companies

3.1 Due Diligence

Due diligence is an essential element prior to committing to any investment, and this is also the case for VC investments. There is, however, a difference between the due diligence investigation typically conducted in a mature company's buy-out transaction compared to such investigation into a start-up or growth company.

The due diligence conducted by VC funds is generally less extensive. An obvious reason for this is that young and growing companies generally have a smaller workforce and less complexity compared to mature companies with a long history. In other words: there is less to investigate. Depending on the type of business, diligence typically focuses on key value drivers for the venture (eg, on intellectual property, permits/licences or certain material commercial agreements).

Another relevant element in the due diligence phase is that the investor will invest in the company and – unless there is also a secondary element – the founder and other shareholders of the company will not yet take their money off the table. Although this does not remove the need for proper due diligence, it does provide comfort to new investors.

In 2020 and 2021, the VC market was booming, and investors were eager to allocate their money and anxious to not miss out on the next unicorn in town. This led to a highly competitive market that drove extremely short due diligence timelines (sometimes even a week or less). Also, presumably due to high interest rates, the uncertainty in the global economy and the geopolitical landscape since 2022, this investment climate became less competitive, and investors have been able to take somewhat more time in conducting proper diligence of their potential targets.

3.2 Process

See **3.1 Due Diligence**.

3.3 Investment Structure

Different Types of Equity

Ordinary shares and preference shares

The share capital of a Dutch limited liability company (*besloten vennootschap met beperkte aansprakelijkheid*) (practically always the legal form of portfolio companies in the Netherlands) consists of ordinary shares/common stock. These ordinary shares are typically held in any event by the company's founder(s), and sometimes also by employees under an employee incentive plan.

When the first early-stage investors make their investment, they generally require that they have a preference over these ordinary shares. For this purpose, they will be issued cumulative preference shares. This means that, in the case of a liquidation/exit event, they are the first to retrieve their investment, typically also with a certain return percentage. Only after the preference shares have received such amounts will the holders of ordinary shares receive proceeds.

Liquidation preference: participating versus non-participating

Preference shares arrangements may consist of *"participating"* or *"non-participating"* preference arrangements, as follows.

Participating

When the participating liquidation preference is agreed, the proceeds of the liquidation will be distributed among the holders of ordinary shares and the holders of preference shares, after the liquidation preference has been paid to the investors holding the preference shares. A participating liquidation preference can be subject to a cap, meaning that the investor is only entitled to the liquidation proceeds up to a certain amount.

Non-participating

When the non-participating liquidation preference is agreed, the proceeds of the liquidation will be distributed among only the holders of ordinary shares after the liquidation preference has been paid to the investors holding the preference shares.

In addition, preference shares are usually convertible into ordinary shares. This is because if the company is performing well, and a non-participating liquidation preference or a participating liquidation preference with a cap has been agreed, holders of ordinary shares may be entitled to a greater share of the liquidation proceeds than holders of preference shares. In this context, the investor will prefer to convert its preference shares into ordinary shares, as it is more economically attractive to do so.

(Convertible) shareholder loans

Some VC funds invest not through equity but through (convertible) shareholder loans. The interest payable on the loan is typically not paid each year, but is added to the principal amount. Subsequently, in the event of liquidation, the entire outstanding amount should be paid to the investor. In this way, a comparable result is achieved to when the fund had invested in preference shares.

In the past, these shareholder loans were mainly used by UK and US investors. Such loans were typically tax-driven: in short, the (accrued) interest payable on such debt would generally be offset against taxable income of the portfolio company, aiming to reduce the corporate income tax payable by such portfolio company. Today, the tax reasons that traditionally drove choosing this type of financing have largely disappeared, mainly due to the fact that the deductibility of interest on both related-party debt and third-

party debt has been restricted at both the EU and national level.

There may, however, still be reasons for using a (convertible) shareholder loan – for instance, in order to remain below certain equity thresholds, to avoid regulatory clearances having to be obtained prior to closing an investment round. Regulatory clearances tend to be time-consuming and costly, while start-ups and growth companies prefer to obtain investments as soon as possible. Working with a convertible loan may be a good solution: the company is able to obtain the funds it desires (and the shareholder/lender the economics it desires), while closing is not delayed.

Depositary receipts for shares issued by "STAK"

A typical feature in Dutch VC or private equity structures is a so-called STAK. This is a foundation that holds shares in a company and issues depositary receipts for such underlying shares. Through this structure, legal ownership and economic benefit of the shares is separated. The voting rights on the shares are exercised by the board of the STAK, but the dividends and liquidation proceeds will be passed on to the holders of the depositary receipt-holders. If structured properly, a STAK is treated as *"transparent"* for Dutch tax purposes.

This feature is commonly used in employee participation plans for the obvious reason that investors may wish to incentivise employees through participation in the company, but may not wish to give them a seat at the shareholders' table. In addition, it keeps the cap table clean, as only the STAK (and not the individual employees) is a shareholder. The board of the STAK is therefore also typically appointed by the portfolio company's main investor.

The use of a STAK may also prove useful in start-ups and growth companies, as initial capital is often provided by a relatively large group of *"friends and family"* and angel investors. Such a large group of shareholders can lead to inefficiencies on a day-to-day basis and also to potential delays when setting up new investment rounds – for instance, because each shareholder will have to agree to the amended shareholders' agreement that will be entered into as part of a new investment round.

Whether a STAK is the appropriate feature for dealing with a large shareholder base should be assessed on a case-by-case basis, as it also means that the diverse shareholder base will have to operate through one vehicle (which requires a certain level of alignment between such shareholders).

3.4 Documentation

Key Documents

The key documents in an investment round vary depending on the structure of the investment. If the investment round consists solely of a VC fund investing in a company, key documents will include the following.

Term sheet

This non-binding document (except typically for exclusivity and cost arrangements, if applicable) will set out the key terms and conditions on which the parties are willing to further negotiate the terms of the investment.

Investment agreement

This agreement sets out the terms of the investment, such as the subscription price and the legal structure of the investment, and may be combined with *"sale and purchase"* element if there is also a secondary as part of the investment rounds.

Shareholders' agreement

This agreement contains the agreements between the various shareholders and the company. These arrangements typically include:

- certain information rights of the shareholders regarding the company;
- drag- and tag-along rights; and
- clauses regarding anti-dilution protection.

Given that in the Netherlands shares are issued and transferred by having a notarial deed executed in front of a civil law notary, notarial documentation is required (eg, deed of issue, deed of transfer, notary letter for funds flow at closing, power of attorney, etc).

The Use of Legal Templates in the Netherlands

Although certain organisations, such as Capital Waters, have taken the initiative of standardising VC documentation, the use of industry-wide legal templates is not as widespread in the Netherlands compared to the USA or UK, where, respectively, the models of the National Venture Capital Association or the British Venture Capital Association are often used.

3.5 Investor Safeguards

Downside Scenario Protection

General

In a downside scenario, the main protection for VC funds will be through the preference shares they hold, which entitle them to liquidation proceeds before the ordinary shareholders receive any proceeds. In addition, VC funds tend to require protection against so-called down rounds, and from being dragged into an exit transaction against a valuation below the valuation at which they invested in the company.

Down-round or anti-dilution protection

VC funds typically invest in companies that have not yet (fully) matured, and the valuation for such companies may be less robust compared to matured companies that have a proven track record. For this reason and others, VC funds generally require protection for down rounds, which are investment rounds subsequent to the VC fund's investment round, at a lower valuation than used in the previous round. If no protection is provided for the VC, such down round will dilute the VC fund disproportionally.

In Dutch VC transactions, down-round protection is provided for by agreeing that the VC fund has the right to acquire additional shares against nominal value. This can be achieved, eg, by applying any of the following methods.

Full ratchet

The investor will be entitled to acquire such number of shares as they would have held had they made their investment against the lower valuation. This formula can be quite unsubtle, as it does not take into account the size of the down round.

Weighted average

Adjustments to the number of shares issued to existing investors will be made depending on the size of the down round. The following most-common types can be distinguished:

- broad-based weighted average formula – this assumes that all shares are included in the average (including options, convertibles, warrants, etc); and
- narrow-based weighted average formula – this assumes that only the outstanding shares are included in the average.

The broad-based weighted average formula is the most commonly used form of anti-dilution protection in the Netherlands. The down-round protection is sometimes subject to *"pay to play"* condition, meaning that the investor only has the benefit of the protection if it participates in the new funding round.

Drag-along protection

VC funds may seek protection not only against down rounds but also against being dragged into an exit at a lower valuation than that at which the VC fund invested in the company.

Shareholders' agreements typically provide for the right that shareholders representing a certain percentage of the shares (for instance, more than 50% or a qualified majority) can require the other shareholders (on a pro rata basis) to co-sell their shares to a third party. The reasoning here is that, if a majority of the share capital agrees to an exit, the minority should not be able to block such an exit. In addition, VC funds require an exit horizon in view of their fund conditions, and therefore a drag-along right may even be agreed at a lower percentage.

However, if investors have invested in the company at different valuation levels, the late investors will generally wish to avoid early-stage investors dragging them into an exit at a valuation below the valuation at which they had invested.

In practice, conditions are seen being attached to the exercise of these drag-along rights, in particular regarding the use of a qualified majority before a drag-along right can be exercised and/or a minimum valuation level for a certain period of time before the drag-along right can be exercised.

3.6 Corporate Governance

Two-Tier Board Versus One-Tier Board

Each Dutch limited liability company has a management board that is responsible for (among other things) managing the company's day-to-day business and strategy, and for representing the company before third parties.

In addition to a management board, a company may have a supervisory board that supervises and advises the management board. This is not required (unless the so-called large company regime, or other specific regulatory requirements, apply). It is also possible to have a one-tier board with the management board consisting of both executive and non-executive directors. It is uncommon for start-ups to have a supervisory or one-tier board, though when a company matures this may become appropriate.

Given the strong presence of foreign investors in the Netherlands (in particular from the US) and their familiarity with one-tier boards, such investors often show a preference for one-tier board set-ups.

Board Representative

If a supervisory board or a one-tier board is present, it is common for VC funds to require one or more seats on a supervisory board, or a non-executive director on a one-tier board. Through these board positions, the VC fund is in a position to closely monitor the company and supervise the management board members, although the statutory rights for such supervisory directors are limited under Dutch law (most notably, information rights and the right to suspend the managing directors). Specific rights (eg, approval rights) are typically agreed upon in a shareholders' agreement (and sometimes also in the articles of association).

It should be noted that a director has the fiduciary duty to act in the best interest of the company (this also applies if it has been appointed upon the nomination of a VC fund). Therefore, VC investors may prefer to obtain influence as shareholder rather than through a director nominated by the VC investor.

Typical approval rights for non-executive or supervisory directors relate to business matters (eg, entering into agreements above a certain threshold, hiring/firing key employees or approving the budget/business plan). The approvals generally require a simple majority, though certain more material matters (eg, material M&A or divestments, and approving/amending the business plan and budget) may require a qualified majority.

In addition to appointing a representative on the board, it is also not uncommon for a VC fund to have the right to appoint one or more observers. The concept of an observer is not recognised under Dutch law. Therefore, the scope and powers of an observer are typically outlined in the shareholders' agreement. In the authors' experience, observer rights are generally limited to having the right to receive board materials and to attend board meetings.

Shareholder Rights

As shareholders, VC funds will have statutory rights attached to their shares (eg, voting rights, the right to attend a shareholders' meeting and – depending on their stake – the right to call a shareholders' meeting).

Other than for certain limited exceptions, in Dutch limited liability companies, resolutions of the general meeting (eg, issuing shares, excluding pre-emption rights, amending the articles of association, and appointing and dismissing management board members) are adopted by a simple majority. This means that a minority shareholder is not able to block such resolutions.

Shareholders' agreements will typically provide for investor protection beyond the protection provided for under Dutch law, in terms of topics and required majorities. There is no one-size-fits-all approach. Each transaction, VC fund and cap table requires its own tailored protection, though in any event key points of attention include:

- the issuance of shares;
- excluding pre-emption rights;
- specific approval rights on business matters;
- related-party transactions; and
- board composition.

It should be noted that the level of control shareholders are able to exercise over the company through contractual arrangements may also impact the necessity of certain regulatory approvals.

3.7 Contractual Protection

Warranties

In VC investment rounds, warranties are primarily given by the company, which in a primary transaction will be the party that receives the investment. If there is (also) a secondary element, the selling shareholders will give warranties.

However, a selling shareholder is typically reluctant to provide detailed business and tax warranties in relation to a business in which it has only been a minority investor for a certain period of time. It is therefore not uncommon for selling shareholders to provide only fundamental warranties (unless the entire transaction solely consists of a secondary transaction, in which case the investor/purchaser may in turn not be comfortable with such approach).

The company receiving an investment in a primary transaction will usually give business and tax warranties. These are usually less extensive than in a full buy-out scenario, though the level of detail also depends to a large extent on the bargaining power of the parties involved.

Recourse

In the case of a warranty breach that has been given by the company, the investor will have a claim against the company. Although additional security on recourse may be appropriate in certain situations, escrow or personal guarantee arrangements are uncommon in such transactions. Also, the use of W&I insurance is not common in VC investments.

When making a damages claim against the company for a warranty breach, the investor should also be compensated for the loss that such damages claim imposes on its own stake in the company (ie, the damages amount must be grossed up). Damages in the Netherlands are usually paid in cash, though it is also possible (and sometimes agreed on) to pay damages in the form of shares.

4. Government Inducements

4.1 Subsidy Programmes

See the Dutch Trends and Developments chapter in this guide.

4.2 Tax Treatment

Dutch tax treatment of an investment in a portfolio company predominantly depends on whether the VC fund is opaque (eg, a co-operative or a private limited liability company) or tax-transparent (eg, a tax-transparent limited partnership) for Dutch tax purposes, as discussed further below. It should be noted that the Netherlands does not have a special tax regime for income and/or gains derived from investments in growth or start/scale-up companies. Therefore, Dutch tax treatment of such investments is, in principle, equal to the Dutch tax treatment of investments made in other types of companies.

Co-Operative and Private Limited Liability Company

A Dutch (tax-resident) VC fund that takes the form of a co-operative or private limited liability company (or another legal form that is opaque for Dutch tax purposes) is, in principle, subject to Dutch corporate income tax on its worldwide profits at a 25.8% rate (a reduced rate of 19% applies to the first EUR200,000 of taxable profits).

However, any income and/or gains derived from an investment in a portfolio company by such co-operative or private limited liability company is generally exempt from Dutch corporate income tax, due to the application of the Dutch participation exemption, provided that (in short) the investment represents an interest of 5% or more in (the nominal capital of) the portfolio company and that certain other conditions are met. In principle, any losses incurred in respect of an investment in a portfolio also fall under the participation exemption (ie, are non-deductible for Dutch corporate income tax purposes), unless certain conditions are met, in which case (part of) such losses may nevertheless be deductible for Dutch corporate income tax purposes.

Tax-Transparent Limited Partnership

A VC fund in the form of a tax-transparent limited partnership (or another legal form that is treated as transparent from a Dutch tax perspective) is not subject to Dutch corporate income tax. This means that any income and/or gains derived from an investment in a portfolio company are,

in principle, not taxed at fund level. Instead, the investment in the underlying portfolio company – and any income and/or gains arising therefrom – are, for Dutch tax purposes, attributed to the investors on a pro rata basis, and are taxed accordingly. In this respect, it should be noted that, in principle, a foreign investor that invests in a Dutch-based, tax-transparent VC fund would – from a Dutch domestic perspective – be regarded as having a deemed Dutch taxable presence, to which the investments in the underlying portfolio companies are attributed.

4.3 Government Endorsement

See the Dutch Trends and Developments chapter in this guide.

5. Employment Incentives

5.1 General

A customary feature in start-ups and growth companies is an employee incentive plan. In short, this is a plan under which employees can participate in the company and profit from its future growth. This is an important feature for incentivising employees to grow the business, and is equally important for attracting talented people (especially since not all start-ups and growth companies are able to offer salaries similar to those with whom they compete for competent personnel).

It should be noted that there may be regulatory constraints to granting employee incentives. A 20% bonus cap applies to Dutch financial institutions, for example, which significantly limits the room for granting employee incentives.

Vesting

To ensure that employees are also inclined to stay at the company and to actually contribute to its success, it is customary for an employee's entitlement to participation to be subject to vesting. An annual vesting of 20% is not uncommon, until 100% is vested at the fifth anniversary of the start of the employment. However, this varies per company.

Leaver Arrangements

To further ensure that employees remain involved with the company and do not leave the company after their package has fully vested, leaver arrangements typically apply. Depending on the reason for leaving the company, the employee may qualify as *"good leaver"* or *"bad leaver"* (sometimes there is also a third category, the *"neutral leaver"* or *"intermediate leaver"*). The consequences of each qualification vary per plan, but *"good leaver"* typically remains entitled to its vested participation rights, and *"bad leaver"* forfeits all its participation rights. *"neutral leaver"* may, for instance, forfeit only a certain percentage of its vested participation rights. In order to protect and stabilise the control and ownership structure of the company, leaver arrangements generally provide for a call option that grants investors or the company the right to purchase the vested participation rights upon a leaver event for the leaver price.

Commonly Used Incentive Plan Structures

The following structures for incentive plans are commonly used in the Netherlands.

Equity plans

Actual shares may be issued in relation to the management incentive plan. To ensure that the employees have the benefit of the economic rights but not of the voting and other rights, these shares are typically issued to a STAK (see also **3.3 Investment Structure**), which in its turn issues depositary receipts for the shares it holds to the participating employees. The board of the

STAK is typically composed of representatives of the investor and sometimes also a representative of the employees, with only specific rights protecting the economic interest of the employees.

Cash-based incentives (including SAR plans)

Cash-based incentives (such as performance bonuses), which become payable upon certain milestones, provide for an efficient way to incentivise employees without a structural impact and/or dilutive effects. Another cash-based incentive that provides an alternative to shares could be the issuance of *"stock appreciation rights"* (SARs) pursuant to a SAR plan. These SARs give the participant a right to a share of the company's value increase (whereby the payment to which the participant is entitled is determined by reference to the increase of the share price over a certain reference value). SARs are typically due and payable at the time a certain trigger event occurs, such as an exit.

Option-based plans

An alternative to the issuance of shares may be the use of an option-based employee incentive plan. Such plan typically provides participants with the option to purchase (depositary receipts of) shares at a fixed price.

Management equity plans

Typically, these incentives take the form of ratchet shares or subordinated ordinary shares (typically referred to as *"sweet equity"*), which provide for a leveraged return after a certain preferred return is realised (in which case, a relatively large portion of (the remaining) profits is typically allocated to the ordinary shares).

5.2 Securities

See **5.1 General**.

5.3 Taxation of Instruments

General

When structuring an incentive pool, a key point from a Dutch tax perspective is typically the moment at which the taxable event for Dutch wage tax purposes occurs. In situations involving growth or start/scale-up companies of which the share value can exponentially increase over time, it is generally preferable to have the taxable event occur as early as possible (when the value may still be relatively low, compared to the value at a later stage). Other key points are:

- the Dutch tax treatment of the pay-out under an incentive for the recipient thereof; and
- any tax benefit available to the company issuing the incentive, such as the deductibility for corporate income tax purposes of the costs associated with the incentive.

Tax Considerations Applicable to Commonly Used Incentives

Equity plans

For equity plans, in principle the taxable event occurs at the moment the shares or depositary receipts corresponding to the shares are unconditionally granted. Whether an unconditional granting of shares or depositary receipts gives rise to the levy of Dutch wage tax depends on whether the fair market value exceeds the price paid by the employee for such shares or depositary receipts. If the fair market value exceeds the price paid by the employee, the excess is taxed as a benefit from employment at the progressive Dutch personal income tax rates, ranging up to 49.5% (maximum rate for 2025).

If an equity plan is subject to vesting, it is usually important to consider the structuring of the vesting mechanism. The reason for this is that, if an equity plan is subject to time- or performance-based vesting, for Dutch tax purposes each

vested portion is generally regarded as being received – and therefore as potentially taxable as a benefit from employment – at the time of vesting. If the value of the shares increases over time, then the later the time of vesting, the higher the potential taxable employment benefit. Therefore, the vesting mechanism is typically structured such that the entire equity incentive entitlement is unconditionally granted at the outset, in combination with a cancellation mechanism, which provides that, upon an employee becoming a leaver, they would forfeit the unvested portion of their employee participation.

Cash-based incentives

The taxable event in respect of cash bonuses or payments made as part of a SAR plan occurs at the moment the entitlement to the cash bonus or SAR payment becomes unconditional. Although typically cash-based incentives are beneficial in the sense that they enable incentivising employees without structural impact and/or dilutive effects, the downside is that these are typically taxed as ordinary income against progressive Dutch personal income tax rates, ranging up to 49.5% (maximum rate for 2025). However, it should be noted that such cash bonuses or SAR payments may, under certain circumstances, be deductible for Dutch corporate income tax purposes in the hands of the company, which may potentially reduce the corporate tax burden.

Option-based plans

For stock options, in principle the taxable event occurs at the moment the shares become *"tradeable"*, which – in short – is the case if the employee is able to sell the shares to another person (and is not or is no longer contractually restricted from doing so). However, an employee may also elect to have the taxable moment occur at the moment the option is exercised (for this, a written request should be made in a timely fashion to the employer). The taxable amount is determined based on the difference between the fair market value of the shares once becoming tradeable (or, if taxation at exercise is chosen, the fair market value of the shares at exercise) and the purchase price or exercise price paid by the employee, which is taxed as ordinary income against progressive Dutch personal income tax rates, ranging up to 49.5% (maximum rate for 2025).

In April 2025, the Dutch government announced that it envisages the introduction of a more beneficial tax regime for stock options granted to employees of certain qualifying start-ups and scale-ups. This beneficial tax regime would comprise of a lower effective tax rate (equal to 65% of the regular personal income tax rates, ranging up to 49.5% (maximum rate for 2025)) and a deferral of taxation to the moment the shares acquired upon the exercise of the stock options are sold. It is envisaged that this new regime will apply as of 2027.

Management equity incentives

For typical management incentives such as ratchet shares or subordinated ordinary shares (*"sweet equity"*), there are typically two relevant distinguishing events from a Dutch tax perspective:

- the moment of the (unconditional) grant/purchase; and
- the moment income and/or gains are derived therefrom.

As for the moment of granting, it is decisive whether the ratchet shares or sweet shares can be considered to have value at the time of the (unconditional) grant and, if so, what such (fair market) value is. Any difference between such

value and the price paid by the recipient may give rise to a taxable employment benefit.

Any income and/or gains subsequently derived after the moment of grant/purchase generally fall under the lucrative interest regime. Under this regime, any income and/or gains derived from lucrative instruments are, in principle, subject to Dutch personal income tax at progressive rates, up to 49.5% (maximum rate for 2025). However, if the lucrative instruments are held through a personal holding company, any income and/or gains derived therefrom may be taxed under the Dutch substantial interest regime at a 31% rate (a step-up rate of 24.5% applies to the first EUR67,804 of taxable income), provided that certain conditions are met (the *"structuring option"*).

It is noted that this structuring option is under scrutiny by the Dutch parliament and the Dutch Ministry of Finance is currently exploring certain potential amendments to the (structuring option laid down in) the lucrative interest regime. In March and April of 2025, the Dutch Ministry of Finance conducted a public internet consultation in which two potential alternatives have been explored, pursuant to which – in short – income and/or gains from lucrative interests would: (i) be taxed solely at the progressive rates of up to 49.5% (in other words, the structuring option would be abolished); or (ii) could, in principle, still be taxed under the Dutch substantial interest regime (in other words, the structuring option would remain available), but at an effective tax rate that is higher than the existing 31% headline rate for regular income from a substantial interest. The results from the internet consultation are currently being examined by the Dutch Ministry of Finance and it is expected that these will be discussed in the Dutch parliament – but it is not yet clear when such discussions will take place.

5.4 Implementation

The steps required to implement a participation plan largely depend on the specific characteristics of the plan. Contractual participation plans, such as SARs, typically involve minimal implementation steps beyond obtaining the necessary corporate approvals and resolutions.

Equity-based plans, however, generally require more extensive implementation. Under Dutch law, the issuance and transfer of shares require notarial intervention, meaning that notarial deeds must be drafted and executed before a civil-law notary. If employees or managers participate in the company's equity through a STAK (see **3.3 Investment Structure**), additional steps are required, including the incorporation of the STAK, the issuance or transfer of shares to the STAK, and the subsequent issuance of depositary receipts by the STAK to the participating managers and/or employees corresponding to such shares issued/transferred to the STAK.

Specifically for management incentive plans (MIPs), which are often seen in a private equity context, the following applies: as negotiating long-form documentation for MIPs before signing the transaction documentation is often not feasible from a timing perspective, investors and management generally aim to agree on a commitment letter plus term sheet prior to or at signing the transaction. Often, the period following signing is used to negotiate the long-form documentation and to commence a tax ruling process with the Dutch tax authorities seeking to confirm the Dutch tax treatment of the managers' investment (see **5.3 Taxation of Instruments** for a description of certain relevant Dutch tax considerations in this respect). Once the tax ruling is obtained (if applicable), the MIP can be implemented through the execution of the relevant notarial documentation. As the tax

ruling process with the Dutch tax authorities can potentially be lengthy (typically the duration of such process ranges from a couple of months up to a year), the implementation of the MIP usually takes place after the completion of the investment round.

6. Exits

6.1 Investor Exit Rights

Transfer- and exit-related provisions in shareholders' agreements typically include:

- a lock-up period;
- a right of first refusal (ROFR) and/or right of first offer (ROFO);
- drag-along rights; and
- tag-along rights.

During the lock-up period, the shareholders are not allowed to transfer their shares. This creates stability for the portfolio company and the cap table, and also avoids the risk that, shortly after an investment by one shareholder at a certain valuation, other shareholders may transfer shares to third parties at a lower valuation. The duration of the lock-up period depends on each situation, though a two- or three-year lock-up period is not uncommon.

After the lock-up, shareholders are typically allowed to transfer their shares to third parties, though subject to a ROFR and/or ROFO. This allows the other shareholders to acquire the shares at the price offered by a third party (ROFR), or to make an initial offer and set the price for any third parties to exceed (ROFO).

In addition, shareholders' agreements provide for a drag-along right by one or more shareholders together selling, for instance, more than 50% of the company's shares, forcing the other shareholders to co-sell their pro rata portion. In order to allow minority shareholders to profit from an exit sale by other shareholders, a tag-along right typically applies if a drag-along right remains unexercised.

6.2 IPO Exits

Most companies in the Netherlands that elect to pursue an IPO – in the form of a listing on the regulated market of Euronext Amsterdam – are relatively mature companies. However, Euronext Amsterdam is also considered to be an attractive listing platform for start-ups and growth companies, providing access to an international and sophisticated investor base, deep and diverse liquidity and good trading infrastructure.

Due to the challenging deal climate, IPO activity has slowed down over the past few years. However, there are various examples of Dutch IPOs by growth companies. Their listings enabled them to tap the capital markets and secure equity funding to accelerate their growth. Examples include:

- Basic-Fit, an operator of fitness clubs, which is listed on Euronext Amsterdam and has successfully closed multiple new equity raises since its IPO;
- Adyen, a financial technology platform, which is listed on Euronext Amsterdam;
- NX Filtration, a provider of direct nanofiltration technology, which is listed on Euronext Amsterdam;
- Avantium, a developer of renewable and circular polymer materials, which is listed on Euronext Amsterdam and Euronext Brussels and has successfully closed multiple equity raises since its IPO;
- Ebusco, a developer of zero-emission buses, which is listed on Euronext Amsterdam; and

- Onward Medical, a medical technology company, which is listed on Euronext Amsterdam and Euronext Brussels, and which recently completed a successful equity raise.

IPO Timeline

IPOs in the Netherlands generally take four to six months to complete. The main factors in this timeline include:

- the prospectus approval process with the Dutch securities regulator, the AFM; and
- the process of preparing the organisation for life as a listed company in respect of, for instance, its corporate governance, financial reporting and controls, as well as attracting new board members.

The right timing for an IPO also depends on the state of the global and local equity markets; a sufficiently favourable IPO window is often limited and difficult to predict with certainty.

The core disclosure document in an IPO is the prospectus, which must be approved by the regulator before publication. The requirements for an IPO prospectus are based on the EU's Prospectus Regulation, which harmonises the prospectus requirements across the EU. Dutch law does not impose any additional substantive requirements on the IPO prospectus. The prospectus must contain all information necessary to enable investors to make an informed investment decision, and should therefore include information on:

- the company's assets and liabilities, financial position, profits and losses, as well as its prospects; and
- the rights and obligations attached to the offered shares.

The prospectus should also include audited financials for the preceding three years, prepared in accordance with International Financial Reporting Standards (IFRS). In 2026, the required reporting period will be reduced to two years.

6.3 Pre-IPO Liquidity

In the Netherlands, there is no multilateral trading facility (MTF) with simplified listing and reporting requirements, which would allow early-stage investors to sell their shares and achieve liquidity pre-IPO/exit. Instead, pre-IPO liquidity is usually created by allowing early-stage investors to sell (part of) their shares to a third party, typically as part of an investment round where a new investor enters the cap table.

7. Regulation

7.1 Securities Offerings

In principle, the offering of (equity) securities, such as shares, to a large group of recipients constitutes an offering of securities to the public, which requires the publication of an approved prospectus pursuant to the EU's Prospectus Regulation. This also applies to the offering of (equity) securities to the public by private companies.

However, there are various exemptions to this prospectus requirement. For example, no prospectus is required if:

- the offering of securities is only addressed to qualified investors (ie, institutional investors);
- the offering of securities is only addressed to fewer than 150 natural or legal persons per EU member state;
- the total consideration for the offered securities is less than EUR5 million; or

- the securities are only offered to existing or former directors or employees of the company, provided that the company makes a document available to them containing relevant information on the securities offering.

7.2 Restrictions

In addition to merger clearances (which are typically less relevant when a non-controlling stake is acquired in a VC transaction), the Dutch Security Screening Act and the required clearances for obtaining a stake in financial institutions are the most notable regulatory clearances when obtaining a (minority) stake in a Dutch company.

The Dutch Security Screening Act

The Dutch Security Screening Act (*Wet veiligheidstoets investeringen, fusies en overnames*, or the *"Vifo Act"*) entered into force on 1 June 2023. The Vifo Act contains an obligation for notification to the Bureau for Verification of Investments (*Bureau Toetsing Investeringen*, or BTI) for transactions relating to target companies active in certain sensitive sectors. A notification obligation may occur when a person acquires:

- control over a company that is active in the field of sensitive technology, that is considered *"vital provider"* or that operates a business campus in the Netherlands; or
- significant influence in a company that is active in the field of highly sensitive technology.

Following notification, the BTI will assess whether the transaction may proceed. A standstill obligation applies during the assessment. The BTI may approve the transaction with or without conditions, or, as a last resort, may prohibit it. In the case of non-EU acquirers, the EU co-operation mechanism is also triggered – in such case, other EU member states will be informed through the European Commission about the transaction, and will be provided with the opportunity to raise comments. It typically takes two to nine months to obtain approval from the BTI.

Clearances for Financial Institutions

The AFM and the Dutch Central Bank (*De Nederlandsche Bank*, or DNB) are the competent financial regulatory authorities in the Netherlands. Investments in the Dutch financial sector or in entities regulated by the AFM or DNB may trigger notification or approval requirements. Most notably, if a person seeks to acquire a direct or indirect interest of 10% or more in certain financial institutions (eg, banks, insurers, payment institutions, crypto-asset service providers and investment firms), a declaration of no objection will be required from the DNB, which typically takes between four and nine months to obtain.

Trends and Developments

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Stibbe is a full-service, leading, independent and international law firm, with its main offices in Amsterdam, Brussels and Luxembourg and a branch office in London. Stibbe's corporate group acts on a wide variety of matters, including strategic and private equity transactions, public M&A, takeover defences, governance and venture capital transactions. Recent notable venture capital transactions the firm has advised on include the following: advising Insight Venture Partners on the acquisition of a minority stake in DataSnipper; advising Picnic on several funding rounds; advising TCV on several funding rounds involving Mollie; advising Mambu on its EQT Growth-led Series E funding round; and advising JP Morgan Growth on its investment in Eye Security.

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General Observations

In 2024, venture capital (VC) investments in the Netherlands amounted to approximately EUR2.0 billion and therefore 2024 currently ranks as the fourth best year ever for VC investment in the country. The number of VC investments declined from 866 in 2023 to 743 in 2024. Additionally, start-ups struggled to secure funding beyond the seed phase. Combined with the absence of mega-investment rounds, this resulted in total investments falling short of the years 2021, 2022 and 2023, which saw EUR4.4 billion, EUR2.7 billion and EUR2.2 billion in VC investments, respectively.

Although these figures indicate a downward trend, the difference between 2023 and 2024 is relatively limited. Whether this trend will continue remains to be seen, but Q1 2025 figures (as published by Golden Egg Check) show a relatively stable continued VC environment with approximately EUR458 million in VC investments.

Unless explicitly referring to a later date, the cut-off date for this chapter of the guide was 1 April 2025. Both growth investments and venture capital investments are referred to as VC investments. Unless otherwise indicated, the statistics in this chapter of the guide are from the Dutch Association for Participation Companies (*Nederlandse Vereniging voor Participatiemaatschappijen*, or NVP), as made available prior to 6 May 2025.

Most Noteworthy VC Transactions in 2024 and Q1 2025

Although the number of major investment rounds were scarce in 2024 and Q1 2025, a number of significant investment rounds took place at Dutch start-ups and scale-ups, such as the following.

- Picnic – online supermarket Picnic raised EUR355 million from its current shareholders. Among the investors was the German supermarket chain Edeka and the founder of Microsoft, Bill Gates. Picnic is using the capital to expand its activities in Germany and France by building new distribution centres, hiring more personnel and acquiring more delivery vans.
- Datasnipper – software company Datasnipper became the first unicorn since 2022, after a USD100 million investment by Index Ventures. The founders of Datasnipper had already sold a minority stake to Insight Ventures in 2022.
- Mews – cloud-based hospitality management platform Mews received a USD110 million investment from its existing investors, including Goldman Sachs Asset Management and Kinnevik. At that time, Mews was valued at

USD1.2 billion, giving it unicorn status. In March 2025, Mews received another USD75 million investment from Tiger Global. Mews' hospitality management platform is designed to streamline operations for hotels, hostels, serviced apartments, and other accommodation providers. Its core offering is the Mews Hospitality Cloud, an all-in-one property management system (PMS) that automates tasks and enhances the guest experience.

- Axelera AI – the Eindhoven-based AI chip start-up Axelera AI secured USD68 million in funding to fuel its ambitious growth plans. Key investors include Innovation Industries, Invest-NL and Verve Ventures, with new investors, such as the European Innovation Council and a Samsung Electronics investment fund, also joining the cap table.
- Nearfield Instruments – Dutch Chip inspector Nearfield Instruments secured EUR135 million in a Series C investment round. Walden Catalyst and Temasek led the funding round, with participation from Innovation Industries, Invest-NL and ING.
- Cradle – biotech company Cradle, a leader in AI-powered protein engineering, secured USD73 million in a Series B funding. The investment round was led by IVP, with participation from existing investors Index Ventures and Kindred Capital.
- Citryll – biotech company Citryll raised EUR85 million in a Series B investment round. The fundraise was co-led by Johnson & Johnson Innovation, Forbion and Novartis Venture Fund, with the participation of Pureos Bioventures, alongside existing investors.
- Leyden Labs – the Leiden-based biotech company Leyden Labs has secured USD70 million in a new funding round. The round was led by Polaris Partners and the Singaporese state investor Temasek.

Exits

The Dutch VC exit market has been slow in 2024 and Q1 2025. As valuations dropped due to the declining deal climate, the exit market has become more challenging. VC investors who acquired stakes in start-ups and scale-ups during peak valuation periods are now facing lower-than-expected returns. Therefore, these VC investors have been holding off exits, waiting for the deal climate to become more favourable.

Despite this slowdown, there have been some notable exits. For example, the shares in the Amsterdam-based biotech company Calypso Biotech have been acquired by Novartis for around USD425 million. Part of the purchase price will be payable after reaching certain milestones. Sellers include M Ventures, Johnson & Johnson Innovation and Gilde Healthcare.

Leading Industries in Dutch VC Market

Traditionally, the largest share of venture capital investments in the Netherlands has been directed towards the ICT, biotech and healthcare sectors. However, recent developments in the Dutch tech landscape have highlighted significant advancements in the climate tech and AI sectors. A notable example of the focus on climate tech is Carbon Equity's fundraising of EUR100 million for the Climate Tech Portfolio Fund II in March 2024. In terms of AI investments, the USD73 million investment in Cradle and the USD68 million investment in Axelera AI are worth mentioning. According to data from Dealroom, a comparison of investments in (sub) sectors in the Netherlands and other European countries shows a higher level of investment in energy and fintech start-ups in the Netherlands.

Venture Capital Fundraising

Contrary to the global trend of declining VC fundraising in recent years, Dutch VC funds had a

record year in 2024, raising over EUR3 billion. The most notable funds raised include the following.

- Forbion Growth Opportunities III (EUR1.2 billion) – focuses on later-stage European and North American biopharma companies developing novel therapies for high medical-need areas.
- Forbion Ventures Fund VII (EUR890 million) – aims to build a portfolio of innovative biotech companies focused on therapeutics, including both established firms and new ventures co-founded by Forbion.
- Innovation Industries Fund III (EUR500 million) – invests in deep-tech companies across the Benelux and Germany. Investors include pension funds such as PME, PMT and ABP, as well as banks like ABN AMRO and Rabobank, alongside public investors such as Invest-NL and the European Investment Fund.
- SET Fund IV (EUR200 million) – targets European start-ups developing digital-first, data-driven solutions to accelerate the mass-market adoption of renewable energy technologies.
- Infinity Recycling Circular Plastics Fund I (EUR175 million) – aims to make 10–14 investments in companies working with waste valorisation technologies that convert end-of-life plastic waste into virgin grade commodities.

These fundraisings highlight strong investor interest in the biopharma, deep-tech and climate-tech sectors in the Netherlands. Additionally, the continued involvement of public investors, such as the European Investment Fund and Invest-NL, remains a positive factor in supporting VC fund growth.

Outlook for 2025

Between 2020 and 2022, the abundance of private capital fuelled a peak in VC activity, creating a founder-friendly market with peak valuations. However, geopolitical instability and rising interest rates from 2022 onwards led to a market cool-down. As a result, the valuations of innovative start-ups and scale-ups, which had skyrocketed during the peak years, have returned to *"normal"* levels. Over the past few years, VC investors have been holding off on exits, waiting for a more favourable deal climate, which in turn has impacted the level of investment rounds.

Despite this and the current volatile macroeconomic and geopolitical environment, Q1 2025 has shown a stable continuation of the level of VC investment activity. The authors expect the Dutch VC market to remain active throughout 2025, mainly driven by declining interest rates (with the ECB lowering interest to 2.25% in April 2025), high levels of dry powder, and continued support from Dutch and European backed VC funds (also in view of the increased sense of urgency of becoming less dependent on foreign countries and investing more in defence, dual-use technologies and deep tech).

Dutch Government's Involvement in the VC Industry

The Dutch government remains an active player in the Dutch VC arena. According to data from Dealroom, out of the ten most active VC funds, five are government backed funds. The Dutch government recognises that VC investments are essential in boosting the energy transition, the healthcare sector and digitalisation. Since recently, this also applies to boosting the defence industry (see the paragraph on VC Investments in the Defence Industry for more information on this specific topic). Therefore, the Dutch government stimulates VC investment by means

of multiple initiatives. Below is an overview of some of the most notable government initiatives related to VC and recent related developments.

Additional financing allocation for Invest-NL

Invest-NL is a private company financed by public resources and with the Dutch Ministry of Finance as its sole shareholder. Invest-NL provides capital investments of between EUR5 million and EUR50 million. At a maximum, Invest-NL's funding covers up to 50% of the total required financing of a start-up or growth company. In addition, the activities of the company requesting funding should be in line with the focus areas of Invest-NL. These focus areas include:

- deep tech;
- bio-based and circular economy;
- carbon-neutral economy; and
- life sciences and health.

Invest-NL was founded in 2020, and has since completed around 135 investments, with total investment amounts of over EUR1 billion. The Dutch government announced in 2024 that Invest-NL shall receive EUR900 million in additional financing until 2029.

Regional development corporations

There are nine regional development corporations, with the Dutch provinces of the relevant region as shareholder. The purpose of these companies is to invest in and strengthen the regional economy. Figures show that approximately EUR220 million has been invested in 2024 by VC investors with the Dutch government as sole shareholder. These VC investors include, most notably, Invest-NL and the regional development corporations.

Phasing-out of the National Growth Fund

The National Growth Fund is an initiative of the Dutch Ministry of Economic Affairs and Climate and of the Ministry of Finance, which managed the fund on behalf of the government. Through this fund, the government invests over EUR11 billion in projects that contribute to the sustainable earning capacity of the Netherlands. Recently, the newly formed Dutch administration announced that the National Growth Fund will be phased out in the coming years.

Extension of the Innovation Credit, Early-Stage Financing and Seed Capital schemes

The following schemes have been extended by the Dutch government.

- The Innovation Credit (*Innovatiekrediet*, or IK) is a scheme intended for companies engaged in the development of clinical and technical development projects. Over the past 15 years, IK has supported more than EUR1.9 billion in private R&D projects through loans. The scheme has co-financed ASML, Nearfield Instruments and many other innovative companies.
- The Early-Stage Financing scheme (*Vroege fase financiering*, or *VFF*) was established in 2014 with the goal of supporting early-stage companies, specifically during the proof-of-concept phase. The VFF focuses on three main target groups: SMEs; innovative start-ups; and academic or college start-ups. The VFF supports companies through an interest-bearing loan, which amounts to 7.71% per 1 January 2025.
- Established in 2005, the Seed Capital scheme aims to strengthen the VC and business angel fund landscape in the Netherlands by providing loans to investment funds. Private investors contribute expertise and capital to start-ups, and the government doubles

their contribution in the form of an interest-free loan with a maximum term of 12 years. The investment per company is between EUR100,000 and EUR5 million.

In October 2024, the Dutch government extended the terms of the IK, the VFF and the Seed Capital schemes until 1 January 2030.

Dutch Investment Bank

In April 2025, a group of leading Dutch entrepreneurs and scientists called on the Dutch government, in an open letter, to centralise the various funding/financing channels into a central government investment vehicle, the Dutch investment bank. According to the authors of the letter, one Dutch investment bank would save overhead costs and provide clarity and scale. According to the authors of this letter, due to the lack of a central investment vehicle, the Dutch government often opts for subsidies, while in certain situations a loan or an equity investment would be the better option. The Minister of Economic Affairs has indicated that the government is working on consolidating the various public investment initiatives in the Netherlands and will announce further steps before the summer of 2025.

Activity of Foreign VC Funds in the Netherlands

Foreign VC funds invest significantly in Dutch companies. Figures show that, in investment rounds, the amount of money invested in Dutch companies by foreign VC funds is comparable to that invested by Dutch VC funds. In 2024, VC investments from foreign investors amounted to approximately EUR906 million and VC investments from domestic investors amounted to approximately EUR987 million. Foreign VC investors, however, primarily participate in larger investment rounds, while smaller investment rounds are mainly driven by Dutch VC investors.

VC Investments in the Defence Industry

In recent years, geopolitical changes have led EU countries to significantly increase their defence spending. The Dutch government acknowledges the urgency of establishing an independent defence industry, as evidenced by the 16.3% increase in defence-related spending since 2020. Private investors have also shown growing interest in the defence sector. According to data from Dealroom, VC investments in the European deep-tech defence, security and resilience start-ups increased from EUR1.1 billion in 2019 to EUR5.2 billion in 2024.

An example of a Dutch VC fund focusing on defence-related investments is the European Defence and Security Tech Fund from Keen Venture Partners, which aims to raise EUR125 million for investing in defence-related start-ups. Another notable investor in Dutch defence-related start-ups is the SecFund. This fund is a co-operation between the Ministry of Defence, the Ministry of Economic Affairs and the above-mentioned Regional Development Corporations. The SecFund provides investments of between EUR150,000 and EUR5 million per company and accounting for not more than 50% of the total investment need for the development of dual-use technology.

Despite the growing interest from investors in defence-related investments, certain bottlenecks remain present. A PwC report prepared on behalf of the Dutch Ministry of Defence identified the following issues in this regard.

- ESG policies – investments in the defence industry may conflict with ESG policies adopted by (VC) investors. Many funds

include provisions that prohibit investments in the defence industry, in particular if raised prior to the war in Ukraine.
- Uncertain business cases – businesses in the defence industry typically have a limited customer base, primarily concentrated among governments. The demand is uncertain and heavily influenced by the geopolitical climate, leading to volatile valuations that can negatively affect (VC) investors' exit opportunities.
- Reputational risks – (VC) investors may be concerned of reputational risks, particularly if geopolitical tensions decrease and the public opinion on defence-related investments shifts, leaving the (VC) investors with a substantial defence portfolio.
- Limited availability of larger tickets – to scale up early-stage companies in the defence industry, larger amounts of venture capital are typically required. Obtaining such large-sized tickets from Dutch and European investors is often still challenging.

The Dutch government acknowledges that it has an important role in ensuring a structural demand and, where possible, in removing bottlenecks for investments in the defence industry. The authors expect the Dutch VC market to continuously focus on defence-related investments over the course of 2025.

Continuous Focus on ESG

Over the last couple of years, the government, society and companies have increased their focus on environmental, social and governance (ESG) aspects. The number of VC funds focusing on impact investment and climate tech has grown. Successful examples of such funds in the Netherlands are Carbon Equity, Infinity Recycling and SET ventures. ESG-related regulation applicable to VC funds has also increased. This began in 2021 with the entry into force of the EU's Sustainable Finance Disclosure Regulation (SFDR). The SFDR requires managers of VC funds to:

- integrate sustainability risks into their investment decision-making processes, and to be transparent with respect to products that target sustainable investment; and
- update product documentation, including prospectuses, websites and ad hoc marketing materials.

In May 2024, the Netherlands Authority for the Financial Markets (*Autoriteit Financiële Markten*) emphasised that it will continue to monitor SFDR compliance by financial market participants, signalling tighter enforcement against non-compliant entities and highlighting a new phase of supervisory attention for accurate SFDR disclosures.

Amendments to the AIFMD

The EU Second Alternative Investment Fund Managers Directive (AIFMD 2.0) entered into force on 15 April 2024, with a local transposition deadline set for 16 April 2026, and it will impact EU funds and their managers. AIFMD 2.0 will introduce a range of stricter requirements that necessitate significant adjustments in the compliance and operational procedures of alternative investment funds and their managers. Areas such as loan origination, risk management and liquidity management will become subject to increased scrutiny, with the aim of compelling alternative investment funds, including EU VC funds, to enhance their internal frameworks and practices to meet the new standards. While these changes may initially pose operational challenges, they are designed to promote greater financial stability, enhance investor protection and mitigate systemic risks within the industry.

ELTIF 2.0

The recent major update to the EU's regulation for long-term investment funds (ELTIFs) also impacts EU VC funds. ELTIF 2.0, which came into force on 10 January 2024, provides alternative investment institutions – including VC funds – with access to new fundraising avenues, greater investment flexibility and a broader investor base, including retail investors across the EU. By extending the scope of eligible investments and taking away certain regulatory constraints, ELTIF 2.0 facilitates a more efficient flow of capital into the VC system. This influx of capital can stimulate innovation, support the growth of start-ups and scale-ups, and enhance the competitiveness of the European economy on a global scale. The ability for VC funds to form fund-of-funds structures and improved cross-border marketing rules further amplifies these opportunities, fostering a more integrated and robust investment environment.

The Netherlands as Fintech Hub

The Netherlands has the EU's second-largest fintech industry, and is third in terms of VC funding in the EU. Banking and other financial services are shifting faster than ever, from brick-and-mortar buildings to online, AI and blockchain. Since the COVID-19 pandemic, fintechs have been on a steep upward trajectory. The Netherlands is recognised as a global front-runner in fintech, in particular payments (with companies such as Adyen, Bird, Botonic, Bunq and Sentilia), and VC funds investing in the Netherlands continue to be active in the fintech sector, following earlier successful capital rounds by companies such as Mollie, Mambu, Finom, PayU and BUX.

NORWAY

Law and Practice

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Thommessen was established in 1856 and is one of Norway's leading commercial law firms. Approximately 320 partners and associates provide advice to Norwegian and international companies as well as organisations in the public and private sectors – ranging from SMEs to large multinational corporations – on transactions, complex projects and contentious matters in all areas of commercial law from the firm's offices in Oslo, Bergen, Stavanger and London. Thommessen lawyers' robust professional legal expertise is combined with in-depth industry knowledge, keeping abreast of trends and developments on an ongoing basis to provide advice that facilitates long-term value creation. Thommessen has one of Norway's largest and most experienced private equity and venture capital teams, providing high-end advice on all aspects of a successful early-stage company's life cycle – from initial capitalisation to Series A, B and C financing, add-on M&A to exit, including structuring of management incentive programme, employment matters, regulatory matters, protection of IP rights, negotiations of business agreements, and tax.

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THOMMESSEN

1. Trends

1.1 VC Market

The Norwegian venture capital market has demonstrated a robust level of activity over the past 12 months, reflecting a growing interest in innovative start-ups and emerging technologies. Nevertheless, the landscape has been characterised by a notable absence of very large deals that typically capture headlines internationally. Notable venture capital-related transactions during the past 12 months include the following:

- eSmart Systems raised NOK 350 million from, inter alia, Tilt Capital and Quanta Service;
- 7Analytics raised NOK46.5 million from Scale Capital;
- Sport AI raised NOK20 million from Skyfall Ventures and MP Pensjon;
- Heimdal Power raised NOK260 million from inter alia Orlen, EnvisionTech (formerly NRP Zero), Investinor AS, Eviny Ventures AS, Sarsia Venture Management AS, Hafslund Invest, and Lyse Vekst As;
- Maritime Robotics raised NOK130 million from Nysnø Klimainvesteringer, Umoe and Holta Invest AS;
- Remora Robotics raised NOK80 million from Frøy Kapital AS, Grieg Kapital AS and Momentum Partners AS;
- Spoor raised NOK43 million from, inter alia, Superorganism, Futurum Ventures, Ørsted and Nysnø Klimainvesteringer;
- Glint Solar raised NOK87 million from Smedvig Ventures, Futurum Ventures, Momentum Partners AS, and Antler; and
- Reduzer AS raised NOK20 million from Momentum, Futurum Ventures and Construct Ventures.

1.2 Key Trends

In 2022 and 2023, the Norwegian venture capital market was impacted by global economic challenges such as geopolitical uncertainty, inflation, and rising interest rates, leading to a decrease in fundraising and more stringent investment conditions. The easy access to capital seen during the pandemic shifted to a landscape of lower valuations and more demanding investors.

While high interest rates and the depreciation of the Norwegian krone moderated Norwegian venture capital activity in 2023, it also made Norwegian investments attractive to foreign investors. With the interest rates stabilising in 2024 and the Norwegian krone remaining weak, international

venture capital funds have become increasingly active in the Norwegian market during the past year. Norwegian venture capital funds continue to be active – although reporting a tougher climate for fund raising and less *"dry powder"* for the years to come (NOK18 billion compared to NOK29 billion in 2018 according to the Norwegian Venture Capital Association).

For many start-up and growth companies, 2024 has been a year of *"make it or break it"*, as venture capital funds are increasingly focused on the high-quality companies and show significantly less interest in participating in down rounds for early-phase companies that are not showing the same traction.

Private equity funds are still increasingly participating in growth equity, which is the space between venture capital and private equity, focusing on minority investments in scaling companies. This shift has led to more competitive negotiations for companies, as private equity funds typically require a solid business plan and clear exit strategies, which may not always align with the interests of other shareholders. The entry of private equity funds into the market has intensified competition among investors for a limited number of established and upscaling companies. This trend is seen as positive for companies in need of financing during their critical growth phases. According to the Norwegian Venture Capital Association Norwegian, private equity funds have also reported to have NOK105 billion in dry powder in late 2024, which is up from the NOK89 billion reported the year before.

Please refer to **3.2 Process** for the impact on deal terms.

1.3 Key Industries

According to the Norwegian Venture Capital Association, the transportation sector, ICT (Information and Communication Technology) and cleantech were the dominant industries in terms of amounts invested in the venture and seed phase in 2023. The writers have observed that these sectors have continued to dominate the Norwegian venture capital landscape in 2024, but that there has been a notable increase in interest in venture capital companies operating in the AI space, driven by emerging mega trends.

2. Venture Capital Funds

2.1 Fund Structure

Domestic venture funds are typically structured as tax-opaque limited liability companies (*aksjeselskap*) or as tax-transparent partnerships (*indre selskap*).

The investment manager acts as the alternative investment fund manager in compliance with the Norwegian Act on the Management of Alternative Investment Funds (the *"AIFM Act"*), implementing the EU's Alternative Investment Fund Managers Directive (AIFMD).

When it comes to foreign structures, it has traditionally been common to choose offshore jurisdictions such as Guernsey, Jersey, and the Cayman Islands. However, there has been an industry shift towards onshore EU/European Economic Area (EEA) jurisdictions such as Luxembourg.

2.2 Fund Economics

In Norway, tax-opaque limited liability and tax-transparent partnership structures – despite a few legal distinctions – largely conform with regard to governance and decision-making pro-

cesses. Fund operations are principally, within the bounds of mandatory law, delegated to the investment manager and regulated by either a shareholders' agreement and investment management agreement or a limited partnership agreement. The terms of fund agreements generally adhere to European best practices for venture capital funds, including Invest Europe and the Institutional Limited Partners Association's principles and model limited partnership agreements.

2.3 Fund Regulation

Equity incentivisation of the investment team is a common feature of venture capital funds in Norway and plays an important role in aligning the interests of the investment team with those of the investors. Typically, the investment team – via a distinct limited liability company – will commit an amount equal to 1-2% of the total commitments to the fund and the fund's equity is usually divided into preference shares and ordinary shares. The preference shares generally have a priority to a repayment of paid-in capital plus a preferred return.

With regard to the carried interest model, most Norwegian venture funds opt for a European waterfall (whole-of-fund model), as opposed to an American waterfall (deal-by-deal model). Norwegian venture funds typically incorporate a claw-back provision in the fund documents to facilitate the repayment of any excess carried interest. Furthermore, the investment team will generally agree to reduce its rights to any accrued or future carried interest if the investment manager is removed for cause. Linear vesting of carried interest may also be included in the fund documents.

2.4 Particularities

Generally, domestic venture funds are classified as alternative investment funds (AIFs) pursuant to the AIFM Act. The Norwegian definition of an AIF implements the definition in the EU AIFMD, meaning that AIFs are collective investment undertakings that are not Undertakings for Collective Investment in Transferable Securities (UCITS) and which raise capital from a number of investors for the purpose of investing the fund's capital pursuant to a defined investment strategy for the benefit of said investors. AIFs must be managed by an external alternative investment fund manager (AIFM) or be managed internally, in practice by its board. The AIFM Act applies to all AIFMs. In the case of internally managed AIFs, the fund itself is considered the AIFM.

All AIFMs must notify the Norwegian Financial Supervisory Authority (NFSA), also known as *Finanstilsynet*, before marketing an AIF to professional investors, and obtain a separate marketing authorisation before marketing an AIF to non-professional investors. As a principal rule, only AIFMs with authorisation – as opposed to AIFMs that are only registered (commonly referred to as *"sub-threshold"* AIFMs) – may market AIFs to non-professional investors.

An exemption to this main rule applies to AIFMs of European venture capital (*"EuVECA"*) funds, which is increasingly common in the Norwegian market. This is an EU/EEA-wide label available to both authorised and registered AIFMs that manage AIFs that are qualifying venture capital funds as defined in the EU Regulation on European venture capital funds. Obtaining registration as an EuVECA manager, and the accompanying right to use the designation *"EuVECA"* in the marketing of qualifying funds, allow for the marketing of the fund to non-professional investors meeting certain criteria and the passporting

of the marketing authorisation across the EU/EEA.

3. Investments in Venture Capital Portfolio Companies

3.1 Due Diligence

The level of due diligence conducted by venture capital fund investors varies a lot, mostly depending on the stage of the target company. In early-stage venture capital investments (seed to Series A/B), the venture capital funds have a strong focus on the commercial/financial due diligence, while the legal due diligence is normally limited to the following topics:

- cap table and dilutive instruments;
- employment agreement for founders and key employees, including incentive programmes;
- ownership to technology;
- material agreements; and
- disputes.

For investments in later-stage companies (Series B/C and later) and in growth companies, the due diligence is normally more detailed and generally in line with what one would typically see in a private equity buyout due diligence.

3.2 Process

In 2022-23, raising financing for growth companies became increasingly difficult. In addition to bringing the valuation down, the anchor investors requested downside protection, while also wanting a larger share of the upside than what their stake would imply if things go well. These factors resulted in more extensive negotiations, complex structures and drafting rounds, and – for many Norwegian VC companies – this has been the case for financing rounds in 2024 as well.

The increased venture capital deal activity in 2024 and so far in 2025 has resulted in less complexity and more efficient processes. Existing lead investors are following up their investment with their pro rata share in the new financing rounds, meaning that the shareholders' agreement to a lesser extent is renegotiated, but often is limited to adding an additional layer of liquidation preference.

New investors normally have separate counsel. Among existing investors and founders, whether they have joint or separate counsel varies, depending on how aligned theirs interests are in the new round.

3.3 Investment Structure

Investors normally invest in start-ups and growth companies by acquiring preference shares, as opposed to common shares. The Norwegian Companies Act allows for separate share classes with different rights if regulated in the company's articles of association. Preference shares generally have rights that are more advantageous than common shares, such as liquidation, anti-dilution and distribution preferences. Venture capitalists and larger investors will accordingly typically demand preference shares, but it is also not in any way uncommon that investments take place in common shares.

3.4 Documentation

In Norway, a venture capital or growth investment is normally done on the basis of:

- a term sheet (optional);
- an investment agreement; and
- a shareholders' agreement.

In order to complete the financing round, a number of corporate documents are also required:

- minutes from meeting of the board of directors in which the share capital increase is proposed to the general meeting;
- notice of and minutes from a general meeting in which the share capital increase is resolved; and
- updated articles of association.

It can be noted that the articles of association in Norwegian companies are normally kept very short, with the majority of regulations – except for share capital, number of shares and any share classes with related rights (eg, liquidation and distribution preferences and voting rights) – being set forth in the shareholders' agreement by and between the company, the founders, investors and any other existing shareholders. There is no established standard for investment documents or shareholders' agreements. However, major early-stage investors and venture capitalists are generally keenly aware of market practice, which ensures fairly similar terms in various investment agreements.

Certain incubators provide templates and resources of varying quality that are often used by start-ups – notably, shareholders' agreements and SLIP agreements (see below) – ensuring similar documentation in many venture deals. Some major early-stage investors also use their own standardised templates for investment agreements, as well as shareholders' agreements for their portfolio companies.

In very early rounds, the investment is often done on the basis of a so-called SLIP (Start-ups Lead Investment Paper, developed by incubator StartupLab), similar to the SAFE instrument that is commonly used in the USA. The concept of the SLIP is that the investor invests in the company against a right to subscribe for shares at minimum (nominal) cost in a future share capital increase. The right to subscribe for shares is normally triggered by the following circumstances:

- an equity financing round of a predetermined amount;
- a corporate transaction of a predetermined size (typically an acquisition or a merger of the company); or
- at the investor's discretion, if so agreed.

The key financial terms are typically a discount and a valuation cap, meaning the highest applicable amount used to calculate the number of shares allotted to the investor. Entering into and executing SLIP agreements is generally less time-consuming than a priced round. Another key benefit is that the company is not valued at a price per share upon execution. This avoids the issue of correct valuation of early-stage companies and allows for incentivising core teams with shares acquired at low value. Further, the SLIP agreement is not a loan, so no interest is paid on the initial amount and there is no maturity date at which the investor can claim repayment.

3.5 Investor Safeguards

Venture capital investors will often require strong downside protection mechanisms, where the following concepts are most common.

- Liquidation preference/exit preference – mechanisms ensuring that the venture capital investor at least gets their investment amount back (either with or without a multiple) before any of the common shares receive any exit or liquidation proceeds are common. It varies as to whether the venture capital investor also has the right to participate pro rata in any remaining proceeds along with the common shareholders (a so-called participating liquidation preference).

- Further, anti-dilution rights are commonly seen, in the event that the company issues new shares at a lower price than the venture capital investors paid. The anti-dilution is facilitated by way of the company issuing a number of additional shares (at nominal value) that are necessary to ensure that the average subscription price of the initial invested shares and the new shares are equal to subscription price in the down round. The anti-dilution mechanism can take into account the number of shares issued in the down round, meaning that a small down round would trigger the issuance of fewer anti-dilution shares than a large down-round (a so-called volume weighted average anti-dilution right) or be a so-called full ratchet anti-dilution right where the size of the down round is disregarded.
- Pre-emption rights and subscription rights – pursuant to the Norwegian Companies Act, existing shareholders have a pre-emptive right to subscribe for new shares issued by the company. The general meeting may, however, through a qualified majority of two-thirds of the votes cast and share capital present at the general meeting, decide to deviate from the pre-emptive rights of existing shareholders. The right for existing shareholders to subscribe for new shares is therefore normally also regulated in the shareholders' agreement.

3.6 Corporate Governance

In addition to exercising influence through their ownership rights (voting at the general meeting), a venture capital investor would normally secure the following rights to influence the management and the affairs of the venture in a shareholders' agreement.

- Board representation – investors may have the right to appoint one or more representatives to the company's board of directors. This allows them to have a say in strategic decision-making and key governance matters.
- Consent rights (reserved matters) – investors may have the right to provide consent or approval for certain significant decisions, such as any changes to the articles of association, the issuance of new shares or other financial instruments, changes to the capital structure, changes to the business activities, undertaking of debt, the entering into of mergers and demergers, agreements relating to acquisitions and disposals, payment of dividends, the entering into large contracts, any substantial investments, or the hiring of key executives.
- Information rights – investors usually have the right to access certain information about the company's operations, financials, and performance.

3.7 Contractual Protection

The type of representations and warranties commonly observed in a financing round in a Norwegian start-up or growth company relate to:

- legal status and corporate power;
- no conflict;
- the issued shares/equity instruments;
- financial statements and sometimes also management accounts;
- position since the accounts date;
- real property and other assets;
- IP rights and IT;
- the General Data Protection Regulation (GDPR);
- material agreements;
- related party transactions;
- employees and pension;
- insurance;
- tax;

- compliance;
- no insolvency;
- litigation; and
- disclosed information.

Normally, the more mature the company is, the more extensive the representations and warranties. It can be noted that, similarly as with M&A transactions, the representation and warranty catalogue is somewhat less extensive/comprehensive than typically is seen in, for instance, the USA.

In terms of recourse in the event of breaches of any representation or warranty, a key point to note is that a Norwegian limited company – as a matter of law – may not indemnify investors in connection with a share capital increase. Any loss for breach of warranties or otherwise therefore needs to be compensated at shareholder level. Normally, this is done through the issuance of compensation shares in the event of a loss, as existing shareholders would not normally be willing to offer any cash compensation to new investors in the event of a breach of warranties by the company. In some cases, the venture capital investor will need to be issued a number of warrants equal to the maximum number of compensation shares, as the issuance of new shares will require the resolution by the general meeting (with a two-thirds majority requirement). In most cases, however, the shareholders will – in the shareholders' agreement – undertake to vote for the necessary resolutions in order to issue the compensation shares. A loss can be defined in different ways, but a common approach is to look at the value reduction of all the shares in the company and multiply it by the investor's ownership share.

4. Government Inducements

4.1 Subsidy Programmes

The Norwegian government offers several programmes to incentivise equity financings in growth companies.

- Innovation Norway offers certain grants, start-up loans, innovation loans and guarantees to support Norwegian growth companies. The government has also backed several seed funds through Innovation Norway aimed at providing financing to growth companies.
- The Research Council of Norway provides a tax deduction scheme (SkatteFUNN), which reduces the costs related to research and development.
- Export Finance Norway provides governmental loans and guarantees for investments in Norway that contribute to exports or to other transactions that generate value within Norway.

Additionally, Norway has signed a contribution agreement with InvestEU for green, digital, small and medium-sized companies financing, which covers financial products and projects under the three InvestEU policy windows:

- sustainable infrastructure;
- research, innovation and digitalisation; and
- small and medium-sized businesses.

Moreover, the Norwegian government invests in numerous growth companies and venture funds, directly or indirectly, in Norway and internationally, through the state-owned investment companies Investinor, Argentum, Nysnø and Norfund as well as through regionally based seed funds.

4.2 Tax Treatment

The Norwegian tax treatment of equity investments in a growth/start-up company does not differ from the general tax treatment of other non-listed companies in Norway. In principle, ordinary income of the fund is taxable for the fund at a rate of 22%.

Norwegian Portfolio Companies

As Norwegian growth/start-up companies are typically established as limited liability companies, equity investments in such companies generally qualify under the Norwegian participation exemption. As a result, capital gains on such shares are tax-exempt. Dividends distributed from such companies are taxed at an effective rate of 0.66%.

Portfolio Companies Within the EU/EEA

Equity investments in growth/start-up companies within the EU/EEA are covered by the Norwegian participation exemption, provided that:

- the EU/EEA entity is a qualifying object under the Norwegian participation (ie, an entity that generally corresponds to a Norwegian limited liability company);
- the respective EU/EEA jurisdiction is not considered a low-tax jurisdiction; and/or
- the EU/EEA entity is genuinely established and carries on genuine economic activities within the relevant EU/EEA jurisdiction.

Portfolio Companies Outside the EU/EEA

Equity investments in growth/start-up companies outside the EU/EEA are covered by the Norwegian participation exemption, provided that:

- the foreign entity is a qualifying object under the Norwegian participation exemption;
- the fund has consistently owned at least 10% of the share capital and controlled at least 10% of the voting rights at the general meeting for a period of two years; and
- the foreign entity is not resident in a low-tax jurisdiction.

4.3 Government Endorsement

The Norwegian government has implemented several material initiatives to increase the level of equity financing of Norwegian growth companies (see **4.1 Subsidy Programmes** for a high-level overview).

5. Employment Incentives

5.1 General

The founders'/key employees' long-term commitment is normally procured by the following.

- Vesting agreements – particularly in early-stage venture capital, where the founders are the majority owners of the company, it quite common that venture capital investors require the founders' shares to be subject to a vesting schedule. Under a typical vesting schedule, the founder will need to sell shares back to the company or other shareholders if they leave the company prior to full vesting. The terms of the sale (including the price) will often depend on the circumstances around a founder leaving (ie, typically *"good leaver/bad leaver"* mechanism). The purpose of the vesting schedule is not only to secure long-term commitment but also to ensure that there is no *"dead equity"* in the company (equity held by persons no longer affiliated with the company), which could make subsequent financing rounds more difficult.
- Shareholders' agreements – shareholders' agreements can include provisions that require founders and key employees to commit to the company for a certain period

through, for instance, a lock-up period for their shares.
- Employee stock ownership plans (ESOPs) – venture capital companies often have an ESOPs in place, allowing founders and key employees to increase their ownership in the company. Such programmes can be option programmes or share purchase programmes. Vesting of options is often time-based, but can also be linked to the achievement of agreed key performance indicators.
- Private equity-style management incentive programmes (MIPs) – some venture capital investors prefer a private equity-style MIP for the companies in which they invest. Such programmes are mostly appropriate for growth companies and not early-stage companies.

5.2 Securities

The instruments/securities used for the purpose of incentivising founders/employees range from co-investments with or without vesting schedules and share option programmes to more complex structures providing substantial gearing to management's investment and a different return profile, with the latter mostly used in growth companies.

Share options are less tax-efficient than other forms of equity-based incentivisation and will normally be most relevant for management incentives in publicly listed companies and early phase VCs.

Reference is made to **5.1 General** regarding terms relating to such instruments.

5.3 Taxation of Instruments

Management of the portfolio companies is generally expected to co-invest alongside the fund. The extent of management's investment typically varies based on their seniority and existing equity holdings that can be rolled. Investments by management are usually structured through a preference and ordinary shares structure. At the fund level, the investment team's investments are typically equity-based and subject to certain limitations as outlined in the AIFM Act (see **2.2 Fund Economics**).

Capital gains and dividends for management are principally fully taxable as capital income at an effective rate of 37.84% minus a risk-free return. However, if management invests through a personal holding vehicle, capital gains and dividends are principally exempt (0.66% tax on dividends). In comparison, employment income is taxed at a marginal rate of 47.4% and subject to national insurance contributions of 14.1%.

5.4 Implementation

Normally, the key terms and structure (including size) of an employee incentive programme is one of the key terms that are negotiated with venture capital investors in a financing round. Such key terms are then set out in the investment agreement and/or shareholders' agreement and, in most cases, left to the (new) board of directors to implement following completion of the financing round. Rarely is the employee incentive programme observed as having any impact on the venture capital investment process as such.

6. Exits

6.1 Investor Exit Rights

In Norway, the shareholders' rights in relation to a sale, IPO or other liquidity event, as well as transfer restrictions and exit triggers, are typically governed by the company's shareholders' agreement. The exit-related provisions typically set out the exit triggers, how the exit process

shall be completed, and how the proceeds shall be distributed among the shareholders. Exit triggers are events or conditions that trigger a potential sale or IPO. Common exit triggers include reaching a certain valuation, achieving specific financial milestones, or a specified time period – the latter of which have become more common in order to give the company time to focus on growth and profitability. The definition of exit triggers can vary depending on the specific circumstances and negotiations between shareholders.

In terms of transfer restrictions, the provisions commonly seen in venture capital companies are as follows.

- Lock-up – lock-up provisions ensure that shareholders (or certain shareholders) do not sell shares for a certain period of time.
- Right of first refusal (ROFR)/right of first offer (ROFO) – ROFR provisions give existing shareholders the right to purchase shares that another shareholder intends to sell before those shares can be sold to a third party. If a shareholder receives an offer from a third party to purchase their shares, they must first offer those shares to the existing shareholders at the same price and terms. The existing shareholders then have the option to accept or decline the offer. If they decline, the shareholder is free to sell the shares to the third party on the same terms. Generally, it can be difficult to achieve an offer from a third party on a stake that is subject to a ROFR, so investors often prefer a ROFO instead, where the shareholder wishing to sell would need to offer the shares to other existing shareholders before the shares can be offered to a third party. If the selling shareholder rejects an offer from other existing shareholders, it can only sell to a third party at a higher price.
- Drag-along rights – drag-along rights allow a majority shareholder or a group of shareholders to force minority shareholders to sell their shares in the event of a sale or liquidity event (typically, an IPO). This provision ensures that all shareholders can participate in the transaction and prevents minority shareholders from blocking a potential exit.
- Tag-along rights – tag-along rights protect minority shareholders by allowing them to join in a sale or liquidity event initiated by a majority shareholder. This provision ensures that minority shareholders have the opportunity to sell their shares on the same terms as the majority shareholders.

6.2 IPO Exits

Although IPOs can be a viable exit strategy for some start-ups, they are not as common in Norway as they are in other countries such as the USA. The prevalence of an IPO exit for start-ups in Norway has varied throughout the years, based on the general sentiment and market conditions. In 2020–22, many early-phase and growth companies were able to obtain high valuations simply based on expected future earnings, and many early-phase and growth companies achieved successful IPO exits around that time due to high investor demand. A record high number of early-phase companies were listed on Oslo Børs' junior market, Euronext Growth Oslo. Euronext Growth Oslo is the most appropriate marketplace for less mature companies, with less-strict listing requirements compared to the Oslo Børs' main list. Many early-phase and growth companies that listed in 2020–22 structured their offering by way of a capital raise through a private placement directed to a handful of institutional investors and high net worth individuals, followed by a listing. Some of the more mature growth companies were listed on Oslo Børs' main list, following a more classic

public offering on the basis of an offering prospectus.

Since 2022, very few early-phase and growth companies have sought an IPO exit, owing to low investor demand. However, many early-phase and growth companies have been able to achieve a decent valuation and secure investors in a private setting. A number of the growth companies that were listed in the period 2020–22 have since been taken private to allow the companies to focus on long-term growth and profitability and relieve them of the quarter-by-quarter scrutiny of the public markets.

6.3 Pre-IPO Liquidity

The need for secondary market trading prior to an IPO in the Norwegian market is rarely observed. There are some companies that are traded *"off the counter"* through the broker desk in Norwegian investment banks. However, the volumes traded are normally limited, which means that it rarely represents an exit opportunity.

7. Regulation

7.1 Securities Offerings

When a Norwegian company is offering equity securities, several legal provisions may come into play. The relevant laws and regulations include, but are not limited to, the following.

- The Norwegian Private Limited Liability Companies Act – this act governs, inter alia, the issuance of new shares and shareholders' preferential rights. The shareholders' agreement supplements the rules of the Norwegian Private Limited Liability Companies Act.
- The Norwegian Securities Trading Act and the EU Prospectus Regulation – these may come into play in large equity offerings. However, it is very rare that an equity offering in an early-stage or growth company is structured in a way that would trigger the obligation to publish a prospectus. There is, for instance, an exemption from the obligation to publish a prospectus if the offer is made to fewer than 150 persons, and this will normally be the case.

7.2 Restrictions

A foreign investor that invests in a Norwegian company may be subject to a foreign direct investment filing obligation in accordance with the Norwegian Act on National Security (the *"Security Act"*). The application of the rules on ownership control, contained in Chapter 10 of the Security Act, presupposes that the undertaking has been brought within the scope of the Security Act by way of an administrative decision pursuant to Section 1(3).

A list of the companies subject to the Security Act has not been published and will not likely become available to the public for national security reasons.

When a company has been brought within the scope of application of the Security Act, the acquirer of *"qualified ownership interest"* in that company must notify the acquisition to the relevant authority. As of now, *"qualified ownership interest"* entails obtaining:

- one-third of the company's stock capital, interests or votes;
- a right to become the owner of one-third of the stock capital or interests; or
- significant influence over the company by other means.

Legislative changes in what is defined as *"qualified ownership interest"* have been adopted

but not yet entered into force (expected during 2024). These amendments entail lowering the threshold for triggering events (ie, definition of *"qualified ownership interest"*) with recurring filing obligations at several levels for the acquisition of direct or indirect holdings of 10%, or an increase to 20%, one-third, 50%,two-thirds or 90% of the share capital, participating interests or votes in the company.

If the authorities conclude that the acquisition may cause a not insignificant risk for national security interests, the authorities may block the transaction or, if the acquisition is already closed, order the acquisition to be reversed.

Outside the scope of application of Chapter 10, Section 2(5) of the Security Act contains a general intervention clause that empowers the authorities to intervene against any planned or ongoing activities (including transactions) that may cause *"not insignificant risk"* to national security. The government has once used this provision to block a transaction where the target was not brought within the scope of the Security Act.

Trends and Developments

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Thommessen was established in 1856 and is one of Norway's leading commercial law firms. Approximately 320 partners and associates provide advice to Norwegian and international companies as well as organisations in the public and private sectors – ranging from SMEs to large multinational corporations – on transactions, complex projects and contentious matters in all areas of commercial law from the firm's offices in Oslo, Bergen, Stavanger and London. Thommessen lawyers' robust professional legal expertise is combined with in-depth industry knowledge, keeping abreast of trends and developments on an ongoing basis to provide advice that facilitates long-term value creation. Thommessen has one of Norway's largest and most experienced private equity and venture capital teams, providing high-end advice on all aspects of a successful early-stage company's life cycle – from initial capitalisation to Series A, B and C financing, add-on M&A to exit, including structuring of management incentive programme, employment matters, regulatory matters, protection of IP rights, negotiations of business agreements, and tax.

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The Recent Evolution of Norway's Venture Capital Landscape

The Norwegian venture capital scene has seen rapid growth in recent years. Oslo is the major hub, with a significant and expanding ecosystem of innovation spaces, accelerators, hubs and investors. Key industrial, educational and financial centres such as Trondheim, Stavanger and Bergen also have a notable presence of start-ups and investors. Major investors are often not limited by geography or sectors, owing to the limited size of the country and market.

Norwegian early-stage companies, predominantly structured as private limited liability companies (*Aksjeselskap*, or AS), operate under the Norwegian Private Limited Liability Companies Act (the *"Companies Act"*). Any reference to *"company"* in this article will be a reference to a private limited liability company. Further, for the sake of ease, start-ups, scale-ups, growth companies or other early-stage companies will be referred to as early-stage companies if not otherwise stated.

The Norwegian venture capital market

Apart from early-stage companies, key players in the Norwegian start-up ecosystem and venture capital market are angel investors, venture capitalists, private equity firms, and incubators/accelerators.

Incubators and accelerators

Several organisations in Norway market themselves as incubators and accelerators, helping start-ups and early-stage companies with key aspects of starting and scaling their businesses – for example, by way of advisory boards and mentoring, business development, office facilities – and also financing by way of direct investment or access to angel investors or venture capitalists. Certain incubators invest by way of their own fund structures and have substantial early-stage portfolios. The incubators are typically centred around key institutions for higher education in Oslo, Bergen and Trondheim and also provide networking for prospective entrepreneurs, helping match founders, investors, advisers and related ideas.

Certain key incubators provide templates and resources that are often used by start-ups, notably shareholders' agreements and SLIP (Start-up's Lead Investment Paper) – akin to the American SAFE (Simple Agreement for Future Equity) – agreements, ensuring similar documentation in many Norwegian venture deals. Some major early-stage investors also use their own standardised and investor-friendly templates for investment agreements, as well as for shareholders' agreements for their portfolio companies.

Venture capitalists and private equity

Norway is home to a significant amount of venture capitalists (including seed funds), family offices and private equity firms. Certain venture capitalists are sector-focused and dedicated to investments in companies in a certain phase. However, the limited size of the market leads some venture capitalists to target opportunities in different stages of development and to invest in venture funds instead of making direct investments.

Recent years have also seen an influx of corporate venture capital by way of venture capital subsidiaries of foreign and domestic blue-chip companies. Typically, the venture capital subsidiaries will invest in or collaborate with start-ups within sectors relevant to the parent company or group in order to drive growth and gain access to new technology and business development.

Government-owned investment arms play a role in funding early-stage companies, particularly Investinor, which is controlled by the Ministry of Trade, Industry and Fisheries and is mandated to manage the Norwegian government's interest in early-stage companies. Investinor, through their subsidiaries and funds, invest directly in the pre-seed, seed and venture capital phases of companies, as well as in other seed and venture funds. They have a regional presence and a focus on sustainability.

Crowdfunding

Recent years have seen an expansion of crowdfunding in the Norwegian market, offering an opportunity for early-stage companies to secure financing. Various platforms offer equity financing and loans provided mainly by retail investors. Low interest rates in 2020 and 2021 contributed to a significant increase in retail investments, many of which were made by way of crowdfunding, driving growth.

The high risk involved in crowdfunded investments has led to increased regulatory scrutiny from the Norwegian government. Rules have been in the making since 2020 and proposed legislation was circulated for comments by relevant actors in 2022. Instead, it has now been proposed to include Regulation (EU) 2020/1503 of the European Parliament and of the Council of 7 October 2020 on European Crowdfunding Service Providers (ECSP) for Business, and amending Regulation (EU) 2017/1129 and Directive (EU) 2019/1937 in the European Economic Area Agreement. This EU regulation regulates both equity- and loan-based crowdfunding of business enterprises. Implementation of the regulation will entail, inter alia, licensing requirements for crowdfunding platforms. Implementation is subject to approval by the Norwegian Parliament, which is still pending.

Venture capital trends

The Norwegian venture capital market is not insulated from macro trends; geopolitical uncertainty, inflation and rising interest rates have all affected financing rounds in all phases in 2024. Compared with the easy access to capital during and after the heights of rate-cutting under the COVID-19 pandemic, companies must now face a different reality of lower valuations coupled with more demanding investors. High interest rates and the aforementioned depreciation of the Norwegian krone against other key currencies has led to a shortened financial runway for some companies and increased the need for earlier financing rounds or bridge financing, while also making pricing in the Norwegian market attractive to foreign investors.

According to Dealroom's report on European tech in 2023, the Norwegian market saw record growth between 2019 and 2023 compared to peer markets and entered into the top 10 European countries for venture capital investments in 2023. Many venture capitalists and private equity funds also made the most of available capital during 2021 and early 2022 by raising significant funds. According to the Norwegian Venture Capital Association, Norwegian funds raised NOK27.5 billion in 2022, which – despite a decrease from the record year 2021 – represents a 60% increase from 2020.

However, data from 2024 suggests that such growth does not represent an enduring change. According to an annual review of early-stage funding of Norwegian technology companies performed by Norwegian venture fund Sondo Capital, financing rounds in the sector in 2024 are largely back at 2020 levels. Although the total amount invested increased from 2023, the number of financing rounds decreased by 25%. Data also indicates that investments by corpo-

rate venture capitalists and crowdfunded investments declined in 2024.

Going into 2025, active venture capital funds and private equity funds remain well funded and have capital to deploy. According to Sondo Capital, the number of unique investors per investment round increased from 2023 to 2024, which indicates that investors have not given up on Norwegian early-stage companies but have become more particular on where and how capital is deployed – thus increasing competition for financing between early-stage companies. Further, the amount of rounds with at least one international investor increased to more than 30%, indicating that Norway remains an attractive market for foreign investment, despite tax concerns (see subsection on *"exit tax"* later in the article).

In line with international trends, private equity funds have joined the fast-growing segment of growth equity – loosely defined as an overlapping space between the venture capital and private equity space – with mandates adjusted to include minority investments in scale-up companies, as opposed to the typical controlling stake in more mature companies. Unlike family offices and the typical venture capital funds, the private equity funds' mandates are normally not adapted to minority investments. Investing in a minority stake may result in more demanding negotiations for companies, as the private equity fund's mandate will typically require target companies to have a clear set business plan and clearly defined exit opportunities. Investors' definitions of good exit opportunities will not necessarily align with those of the other shareholders – for example, certain private equity funds' aversion to IPOs, due to an IPO typically requiring a lock-up of shareholding that prevents a quick and clean exit.

The private equity influx, primarily targeting companies with established market positions and ongoing upscaling activities, has increased competition between sponsors and investors – hereunder more traditional venture capitalists – as the amount of viable target companies has not increased at the same rate as the growth in available capital. In a venture capital market dominated by early-stage investments, increased investment in scale-ups and more mature growth companies is a welcome development for companies seeking financing in the critical make-or-break phase.

At the deal level, an ongoing trend is that venture capitalists acquire lower shares of equity, yet have not reduced their demands for influence. This makes board representation, veto rights and reserved matters key points of negotiations.

Exit opportunities

2020 and 2021 saw a surge of IPOs, with a peak of 68 listings in 2021. A significant number of the companies in question – many of them early-stage technology companies – were listed on the multilateral trading facility Euronext Growth Oslo. With lighter reporting requirements and simplified listing requirements, Euronext Growth is attractive for SMEs and has therefore provided a potential exit opportunity for venture capitalists and other shareholders.

However, the IPO activity cooled in 2023, which saw seven listings across Euronext Growth and the regulated marketplaces. IPO activity increased somewhat in 2024, with 19 listings in total. At present, a large uptick or downturn in activity levels is not expected for 2025 – further indicating that 2020 and 2021 were anomalies.

For many of the early-stage companies listed in 2020 and 2021, equity financing remains hard to

come by and valuations remain low. The end of 2024 saw an increase in public takeover offerings and this trend is expected to continue, aided by the aforementioned weakening of the Norwegian krone versus other key currencies.

Sectors

According to the latest activity report by the Norwegian Venture Capital Association, IT, life sciences, chemicals and materials and cleantech were the dominant industries in terms of amounts invested in the venture and seed phase in 2022 – with IT the clear leader, also driven by the emergence of various forms of AI and related technologies. According to Sondo Capital's annual review, the emergence of AI technologies continued to drive venture investments in the technology sector in 2024, along with software as a service (SaaS) and hardware companies.

The Norwegian economy remains reliant on the oil and gas industry. Key sectors for corporate venture capitalists are therefore technology related to various forms of renewable energy, such as the nascent supplier industry surrounding offshore wind or the numerous initiatives within green and blue hydrogen.

Stricter regulations and environmental requirements in the fisheries and aquaculture industry – which holds a key position as the second-largest export industry – have also led major industry players to invest in and support initiatives and ideas that will limit pollution and improve animal welfare.

Easy access to renewable electric power may also make Norway a hub for data centres in a rapidly digitalising world. As such, global tech giants have already made early-stage investments in land and electric power.

Exit tax

In 2024, the Norwegian government proposed a tightening of the so-called *"exit tax"*, aimed at closing tax loopholes utilised by individuals and businesses relocating their operations or investments outside the country. The tax was enacted by the Norwegian Parliament along with the fiscal budget for 2025, with certain regulations in effect from 20 March 2024.

The exit tax is designed to capture unrealised capital gains when individuals or companies leave the country. The initiative raised concerns among early-stage companies and their founders, who typically have unrealised gains or artificially high tax valuations, as well as among investors, who fear that the tax could deter innovation and entrepreneurship in Norway. The initiative has led a few founders to relocate to more tax-friendly jurisdictions during 2024 and, in general, to founders becoming more tax-conscious at an earlier stage in their growth journey. As a result, many in the Norwegian venture scene are concerned about an outflow of talent and capital from Norway and – conversely – that businesses and talent will refrain from relocating to or establishing activities in Norway.

Although the tightening of the exit tax dominated the news in 2024, it remains to be seen what effect the new rules will have on the total level of investments in Norwegian early-stage companies.

Governmental support and initiatives

Amended share option tax scheme for early-stage companies

Share options are a common way of incentivising employees in start-ups and early-stage companies. Normally, exercising share options with a strike price below the fair market value of the

shares will result in a taxable benefit, which is taxed as salary.

However, from 2022 onwards, the Norwegian Tax Administration have implemented a new scheme for taxation of share option programs that meet certain requirements. Normally, the difference between strike price and market price is immediately taxable as salary for the option holder. For qualifying option schemes, the difference will be taxed upon realization of the shares and taxed as capital gains, not salary, meaning that the company does not need to pay payroll tax.

Requirements were updated in March 2025 – specifically, regarding the age of the company and the number of employees. This slightly increased the scope of the scheme.

A few key requirements are that:

- the option holder must not control more than 5% of votes and shares in the company:
- share options must be issued after 1 January 2022;
- the company must be younger than 12 years at the time of issue (increased from ten years); and
- the company must not have more than 150 employees (increased from 50 employees).

Innovation Norway

Innovation Norway (IN) is a state-owned company intended to stimulate entrepreneurship in Norway by way of grants, loans, guarantees and other services. IN have offices in 30 countries. For start-ups, they provide courses and advisory services (including with regard to IP rights), as well as financial services – namely, grants for market clarification, grants for commercialisation, innovation loans, start-up loans, grants for innovation contracts and growth guarantees.

In 2023, IN contributed approximately NOK7.1 billion to development and innovation in Norwegian businesses. Around NOK2 billion was granted to founders in 2023, up from NOK1.5 billion in 2022. A key result of the support is that it statistically unlocks other financing. According to IN, NOK1 provided as capital or advisory services is matched by NOK1.5 in self-financing and other financing, amounting to an estimated NOK19.6 billion provided to Norwegian companies in 2023.

Regulations on investment

As a general rule, investments in Norway by a foreign person are not regulated and do not require approval by the authorities. Norway's approach to investment regulation offers a stark contrast to more restrictive frameworks seen in other countries, such as the USA's Committee on Foreign Investment in the United States (CFIUS) framework. Norway's liberal stance towards foreign investments, barring certain national security considerations, provides a welcoming environment for international investors.

Foreign direct investment (FDI)

The only regulations pertaining to investments by a foreign person are related to national security and sanctions, primarily the Act Relating to National Security (the *"Security Act"*) (*Sikkerhetsloven*). A company may be brought under the scope of the Security Act if it handles classified information, information or infrastructure of major importance for fundamental national functions, or activities of major importance for fundamental national functions. Where an undertaking/company has been brought within the scope of the Security Act, an acquirer is obliged to notify the relevant ministry if it is acquiring a

qualified ownership interest. As of March 2025, the lowest threshold constituting qualified ownership interest is one third of shares or votes. Unlike antitrust notifications, the prior notification does not have suspensory effect – although, if approval is refused post-closing, it will require a reversal of the transaction.

However, certain amendments of the investment screening regime were adopted in 2023 and are expected to take effect during the second half of 2025. The pending amendments to the Security Act include:

- the lowering of the filing threshold to 10% of the shares, interests or votes in the target (a significant reduction compared to the current threshold of one third);
- the extension of the filing obligation to the seller and target, in addition to the acquirer;
- the application of the filing obligation to qualifying investments in all companies holding a security clearance of *"confidential"* or higher (ie, not only companies that have been brought within the scope of the Security Act by a prior administrative decision); and
- the introduction of a standstill obligation and a prohibition against sharing information that may be used for security-threatening activities before closing.

These changes will result in an increase in the number of deals that require FDI filing in Norway.

Furthermore, a relevant government ministry – within its jurisdiction – may make a decision that rules on ownership change shall apply to:

- companies/undertakings that have significant relevance to fundamental national functions; or
- enterprises that have substantial importance for national security interests, without a direct connection to a fundamental national function.

Also, the executive branch of government has an ex officio provision under the Security Act, allowing the government to intervene in activities that *"may entail a not insignificant risk that interests of national security will be threatened"*. This provision applies irrespective of ownership thresholds.

In late 2023, a government-appointed commission proposed several amendments to the Norwegian FDI regime. Proposals relevant for the venture capital sphere include:

- the implementation of a screening process for all investments in companies within security-sensitive sectors;
- a voluntary notification system whereby investors can increase predictability by notifying the government of their intention to invest in sectors not defined as security-sensitive; and
- a distinction between foreign investors from the European Economic Area and investors from third countries.

For certain sectors, only investors from third countries will need to notify the authorities of their intention to invest. The Norwegian government is working towards a proposal for a new act on control of foreign investments based on the commission's work. The timing of this proposal is still uncertain, but when adopted it will likely bring about substantial changes to Norway's FDI screening system.

It is uncommon for early-stage companies to be covered by the Security Act. The proposed rules

will result in a significant increase in transactions to which the FDI regime is applicable, but most venture capital investments are unlikely to be subject to FDI regulations.

Investment methods

Investment methods in Norway's venture capital market are varied and adaptable to the needs of both investors and companies, but remain generally stable. Preference shares (often favoured for their favourable terms) and convertible instruments (popular as bridge financing tools) are among the common investment methods. The emergence of the SLIP agreement illustrates the market's adaptability and represents an increasing trend in recent years.

Private limited liability companies

As mentioned initially, Norwegian start-ups and early-middle-stage companies are almost exclusively private limited liability companies, governed by the Companies Act. Investors normally use special purpose vehicles incorporated as private limited liability companies, owned by holding companies that may or may not be part of a fund structure. Venture capitalists and private equity funds may also use entities in fund jurisdictions (eg, Guernsey or Luxembourg) to invest directly. As the Norwegian market becomes more attractive for foreign investors, an increase in foreign investment vehicles is expected.

Other than share capital and the regulation of any share classes, there are few relevant statutory requirements to a company's articles of association, allowing shareholders great flexibility to regulate corporate governance and shareholders' rights in a shareholders' agreement. General shareholder rights are set out in the Companies Act.

Preference shares

Investors normally invest in early-stage companies by acquiring preference shares, as opposed to common shares. However, note that investments in common shares only also are fairly common, especially in earlier financing rounds.

The Companies Act allows for separate share classes with different rights if regulated in the company's articles of association. Preference shares generally have rights that are more advantageous than common shares, such as liquidation, anti-dilution and distribution preferences. Venture capitalists and larger investors will typically demand preference shares when negotiating investment terms.

Use of convertible securities and instruments

In the current market, convertible loans are sometimes used as bridge financing between financing rounds – for example, if companies want to raise funds while postponing major rounds. Convertible loans are also sometimes used as a means of financing in their own right (eg, owing to generally lower interest rates than regular loans).

More common than ordinary *"convertible loans"* is the use of the aforementioned SLIP agreement (developed by incubator Start-upLab). The SLIP agreement is often used in angel investments and seed rounds and is normally converted in later financing rounds. The investment provides the investor the right to subscribe for shares at minimum (nominal) cost in a future financing round. The right to subscribe for shares is normally triggered either:

- by an equity financing round of a pre-determined amount;
- by a corporate transaction of a predetermined size (eg, an acquisition or a merger) or

• at the investor's discretion.

The key terms are typically a discount and a valuation cap, meaning the highest applicable amount used to calculate the number of shares allotted to the investor.

SLIP agreements are generally less time-consuming than negotiating investment agreements. Another benefit is that a price per share valuation of the company is not required, avoiding valuation discussions that may be difficult for early-stage companies and tax issues when employees are incentivised with shares acquired at a low price. Further, the SLIP agreement is not a loan, but an equity instrument, so the investors carry equity risk while there is no interest on the investment amount and no maturity date.

In the current economic landscape, characterised by high interest rates, expensive financing and challenging valuations, SLIP agreements continue to be a popular alternative for companies seeking capital. For investors, SLIP agreements are a useful tool to make the most of the current market and to secure favourable terms and higher returns.

POLAND

Law and Practice

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Kondracki Celej specialises in technology transactions, corporate and new tech law. The team advises domestic and international venture capital funds and investors, as well as technology start-ups, on all types of transactions, including venture capital investments, M&A, venture debt, exits and all forms of acquisitions. Recent engagements include a number of high-profile cross-border venture capital transactions – including advising bValue Growth Fund on strategic investments in companies such as Fudo Security or Solidstudio; vLayer Labs on a USD10 million pre-seed round led by a16z, alongside Credo Ventures; and on a EUR4.4 million Pre-Series A financing of Prosoma, a digital health start-up.

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1. Trends

1.1 VC Market

The past 12 months in the Polish venture capital (VC) market were marked by relative resilience in the face of challenging macroeconomic conditions and a transitional period in public funding. Although the total value of VC investments declined slightly year-on-year, several landmark transactions highlighted the maturity and internationalisation of Poland's innovation ecosystem. The most prominent activity was observed in the later stages of financing, while early-stage funding experienced temporary contraction due to a gap in EU-backed capital deployment, largely driven by the prolonged implementation of new EU funding instruments.

Key financing rounds included:

- ElevenLabs, a generative AI start-up specialising in synthetic voice generation, closed a USD180 million (approximately EUR165 million) Series C round in January 2025. The round was led by Andreessen Horowitz and ICONIQ Growth. The transaction valued the company at USD3.3 billion, making ElevenLabs *"triple unicorn"* achieving unicorn status in the USA, the UK and Poland due to its operational and founder base.
- Ramp, a fintech infrastructure provider enabling crypto-to-fiat transactions, raised USD70 million (approximately EUR64 million) in a Series B round co-led by Mubadala Capital and Korelya Capital. It ranks among the largest Polish VC rounds in history, with participation from existing backers Balderton Capital and Cogito Capital, signalling continued international interest in regulated crypto infrastructure.
- ICEYE, a space-tech company with Polish roots, raised EUR118 million in a Series E round, including an extension in Q4. Investors included BlackRock and Finland's Solidium, making it the largest VC financing involving a Polish co-founded company.
- Kontakt.io, focused on indoor IoT infrastructure, secured approximately EUR27 million to scale its operations, reflecting investor interest in industrial automation and B2B platforms.
- Wordware, a start-up building AI-native tools for software developers, raised EUR28 million in a Series A round. The deal was led by international funds and executed abroad, making it one of the largest Polish Series A rounds to date and a strong signal of investor appetite for AI and developer tools infrastructure.

Additionally, several companies engaged in venture debt or structured revenue-based instruments, although most such transactions remain undisclosed or confidential.

Notable exits included:

- Shoper S.A., a leading e-commerce platform, completed a secondary transaction in which cyber_Folks S.A. acquired 49.9% of shares for EUR128 million, representing one of the most significant VC-backed exits to date.
- Wellbee, a digital mental health platform, saw a majority stake acquired by Benefit Systems S.A. in late 2024. The transaction delivered a full exit for Tar Heel Capital Pathfinder, with a reported 10x cash-on-cash return, while bValue retained a minority interest to support further growth.
- Eway, a producer of electric vehicle charging stations, was sold by Rubicon Partners, which exited the investment in 2024 after supporting the company through its scale-up phase. The transaction represented Rubicon's sixth successful VC exit in Poland.

No VC-backed IPOs occurred during the period. While NewConnect (an alternative trading platform operated by the Warsaw Stock Exchange, designed for smaller and early-stage companies) remains a potential route to liquidity, most venture-backed companies pursued trade sales or structured secondaries, reflecting broader global trends in exit timing.

1.2 Key Trends

The VC environment in Poland remained under transitional pressure throughout 2024. A significant number of domestic VC funds had reached the end of their investment periods under the previous EU financial regime (POIR, or Intelligent Development Programme), while newly established vehicles under the FENG (European Funds for a Modern Economy) programme, the new EU funding instrument, had not yet commenced operations. This interim shortfall in available capital contributed to a measurable decline in early-stage deal volume, especially in seed and pre-seed rounds.

As a result, bridge financing gained prominence, as companies faced extended fundraising timelines. Many investors provided interim funding in the form of convertible instruments with downside protection while waiting for larger financial rounds to materialise.

Early-stage companies frequently relied on convertible loan agreements (CLAs), which gained popularity due to their structural flexibility and expedited execution. CLAs allowed investors to defer pricing negotiations and provided founders with runway without immediate equity dilution.

From a deal structuring perspective, the subdued global outlook reinforced investor-favourable terms, particularly:

- Stronger anti-dilution protection, including broader application of full ratchet clauses in down rounds.
- Increased prevalence of liquidation preferences and seniority stacking across funding rounds.
- Greater scrutiny over vesting schedules and founder lock-ups, particularly in cases where follow-on funding was conditional on milestone achievements.

Another visible trend was the growing role of international co-investors. Foreign VC funds, particularly from Western Europe and the USA, accounted for more than half of the total capital deployed into Polish start-ups – a clear indicator

of Poland's growing visibility on the global innovation map. Domestic funds increasingly played a supporting or syndicate role in rounds led by global VCs.

Geopolitical developments, particularly ongoing instability linked with the war on Ukraine, also influenced sectoral focus. As EU security priorities evolved, there was a marked shift in investors' interest towards start-ups operating in defence, dual-use technology, cybersecurity and aerospace. Start-ups developing solutions for defence-related needs – such as unmanned aerial systems, satellite-based surveillance, secure communication networks and AI-powered threat detection – gained increased interest from both domestic and international investors.

1.3 Key Industries

Several sectors stood out as key drivers of VC activity in Poland over the past 12 months. Most notably:

- *Artificial intelligence:* Start-ups such as ElevenLabs, Pathway and Wordware captured substantial investor interest and media attention. As noted in **1.1 VC Market**, the sector attracted several of the largest funding rounds of the year. AI-related solutions were applied across a range of verticals, including automation, analytics and developer tools, confirming the growing role of AI as a cross-cutting area of innovation within the Polish start-up ecosystem.
- *Space and aerospace:* The growing investor interest in Poland's aerospace sector reflects a broader trend of aligning technological innovation with national and regional security priorities. High-profile rounds, such as ICEYE's, helped bring visibility to local capabilities in satellite systems, autonomous platforms and aerospace infrastructure.
- *Cybersecurity and data infrastructure:* In 2024, Poland's cybersecurity and data infrastructure sectors attracted significant investor attention. As AI applications grow, so too does the importance of data security and processing. Several funding rounds in this domain highlighted investor interest in Polish engineering talent and scalable architectures.
- *Healthcare and life sciences:* The healthcare sector continued to attract steady venture interest, particularly in companies developing digital health tools, clinical diagnostics and medtech platforms. This reflects broader regional trends as well as increased interest in health resilience and preventative care following the pandemic period.
- *E-commerce and SaaS platforms:* Companies such as Shoper and Saleor Commerce drew further institutional backing, with exits and growth-stage investments in retail tech and platform-as-a-service models.

There is a clear distinction between industries driving early-stage versus those driving exit activity. While AI and deep-tech continue to attract seed and Series A funding, exits remain concentrated in more mature SaaS and e-commerce ventures. These companies, having built scalable business models and demonstrated stable revenue generation, were better positioned for acquisition, resulting in a higher incidence of successful exits.

2. Venture Capital Funds

2.1 Fund Structure

VC funds in Poland are most commonly structured as alternative investment companies (*alternatywna spółka inwestycyjna*, ASI). This legal structure, introduced under the Act on Investment Funds and Management of Alterna-

tive Investment Funds (*Ustawa o funduszach inwestycyjnych i zarządzaniu alternatywnymi funduszami inwestycyjnymi*), and supervised by the Polish Financial Supervision Authority (KNF), provides a relatively flexible framework for VC activities.

Depending on the size, complexity and investment strategy, an ASI may be structured in one of two forms:

- an internally managed ASI, where the VC fund itself assumes responsibility for portfolio management and risk supervision; or
- an externally managed ASI, where a licensed or registered general partner performs management services.

In practice, the vast majority of Polish VC funds operate as externally managed ASIs below the regulatory threshold of EUR100 million in assets under management, thus benefiting from a lighter regulatory regime. In such cases, the general partner is only subject to registration with the KNF, rather than having to undergo full authorisation. Should the assets of the fund under management exceed EUR100 million (with leverage) or EUR500 million (without), requirements for full licensing and extended supervision of the KNF apply – although this remains rare in the Polish VC segment.

Fund vehicles are typically structured as limited liability companies (*spółka z ograniczoną odpowiedzialnością*) or limited joint-stock partnerships (*spółka komandytowo-akcyjna*).

The operation and governance of a Polish VC fund are typically defined by two key legal documents:

- a limited partnership agreement (LPA), signed among the limited partners, general partner and the fund – covering capital commitments, governance, fees and rights. This document is private and not subject to public disclosure; and
- the Articles of Association or statutes (AoA), which are filed with the National Court Register (KRS) and provide the formal legal framework for the fund entity.

Decision-making authority typically resides with the general partner, which holds final responsibility for investment and fund management decisions. An investment committee – appointed from among the limited partners – often plays an advisory or consultative role in evaluating potential transactions or exits. Corporate governance provisions – including veto rights, investment thresholds and conflicts policies – are typically reflected in the LPA.

While the majority of VC funds targeting the Polish market continue to be domiciled locally, there is an observable and growing trend towards establishing fund structures in international jurisdictions such as Luxembourg or the Netherlands. This shift is particularly evident among vehicles with cross-border investment strategies or those aiming to attract significant commitments from institutional limited partners (LPs) such as the European Investment Fund (EIF).

2.2 Fund Economics

Polish VC funds follow international norms in fund economics, with *"2 and 20"* model being the market standard.

Fund managers are typically entitled to:

- an annual management fee, ranging from 2% to 2.5% of committed capital, used to cover operating and team costs; and
- carried interest, commonly set at 20%, payable upon exceeding a predefined hurdle rate (usually 6–8% IRR), following a capital return waterfall.

Fund managers (or the general partner) are also expected to make a commitment into the fund, usually between 1% and 3% of the total fund size, to ensure alignment of interests with LPs. Institutional LPs – including entities such as the EIF or PFR Ventures – often view a meaningful commitment as a signal of manager confidence and long-term alignment.

Over the past several years, Polish VC funds have increasingly converged with international best practices when it comes to investor protection and governance. Key terms now widely adopted include: (a) investor protection provisions regarding liquidity preferences, claw-back and escrow, removal rights and conflict-of-interest policies; and (b) governance provisions regarding reserved matters, reporting and investment committees.

2.3 Fund Regulation

VC funds in Poland are primarily governed under the Act on Investment Funds and Management of Alternative Investment Funds and supervised by the KNF.

Most VC funds qualify as small ASIs, which manage assets below the thresholds set out in the EU AIFM Directive. These vehicles are subject to simplified regulatory requirements:

- general partner notification-based registration with the KNF;
- limited reporting obligations; and
- exemption from the full licensing regime.

Funds exceeding the thresholds (EUR100 million with leverage or EUR500 million without) require a full licence. This authorisation must be secured through a formal licensing procedure before the KNF, which involves submitting extensive documentation relating to the fund manager's structure, governance, risk management, capital adequacy and compliance systems. However, such cases remain rare within the Polish VC ecosystem due to the relatively small size of most venture funds and the standard industry practice of operating without leverage.

2.4 Particularities

A distinctive feature of the Polish VC ecosystem is the strong involvement and role of the public sector, particularly through fund-of-funds programmes co-ordinated by:

- PFR Ventures, the VC arm of the Polish Development Fund (PFR);
- NCBR (National Centre for Research and Development), which supports innovation-focused investment initiatives; and
- BGK (Polish Development Bank), which co-finances VC activity through guarantee and capital instruments and also operates its own VC fund.

Most of the active VC funds in Poland have received capital through public co-investment schemes, typically structured via dedicated programmes such as Bridge VC (NCBR), CVC, Koffi Biznest and Starter (PFR). Public LPs generally provide 50% to 80% of total fund capital, with private capital raised alongside.

Publicly-backed funds are bound by geographic and SME allocation mandates, as well as R&D alignment criteria. Funds that successfully complete these programmes often subsequently go on to raise fully private vehicles, relying on their existing track record and management infrastructure.

Finally, the launch of FENG-backed funds in 2025 is expected to drive a new wave of early-stage activity, particularly in the AI, healthtech and industrial automation verticals, contributing to greater sectoral specialisation within the Polish fund landscape.

3. Investments in Venture Capital Portfolio Companies

3.1 Due Diligence

Due diligence conducted in Polish VC transactions is typically limited in scope and oriented towards identifying material risks rather than producing a full-scale audit of the target company. The process usually results in *"red flag report"* focused on deal breakers, ie, issues that could significantly affect valuation, enforceability or post-investment stability.

Key areas of the limited legal due diligence include:

- confirmation of the title to shares and the cap table, including prior issuances, transfers and compliance with pre-emption rights;
- confirmation of intellectual property ownership, including proper assignments from founders and key employees, which is particularly critical in technology-driven targets;
- review of public aid and grant funding, especially where the company has benefited from NCBR or EU programmes – investors typically verify potential claw-back obligations, compliance with funding conditions or use restrictions; and
- examination of existing contractual arrangements, with particular focus on key commercial agreements and employment structures.

The due diligence phase is usually initiated following the signing of a term sheet and can extend up to two months, depending on the company's development stage, investor requirements and complexity of funding history.

3.2 Process

A new financing round in a Polish growth company typically begins with the negotiation of a term sheet. Once the term sheet is agreed, due diligence is conducted in parallel with the preparation of investment documents.

Most Polish start-ups are incorporated as limited liability companies (*spółka z ograniczoną odpowiedzialnością*), and new financings are usually structured through the issuance of new shares offered to the investors. This requires a corporate resolution on the capital increase and adoption of the new AoA, with attention paid to anti-dilution rights, pre-emption rights and consents of existing shareholders.

From a procedural standpoint:

- investors subscribe for newly issued shares through a share subscription agreement (in a joint-stock company) or a declaration on joining the company and subscription of shares (in a limited liability company);
- funds are transferred directly to the company's account, after the shares were subscribed by the investors; and
- registration of the updated capital in the KRS must be filed following the shareholders'

resolution and subscription of shares, and the increase becomes effective upon registration.

In terms of stakeholder dynamics during a new financing round:

- existing investors often retain information and pre-emption rights, and in some cases anti-dilution protection. In negotiations, they often act collectively through joint legal counsel. Their primary focus is usually on preserving their rights and ensuring fair treatment in the capital structure post-transaction;
- new investors, particularly the lead investor, generally engage independent legal counsel and are involved in drafting or revising key transaction documents such as the investment and shareholders' agreements and AoA; and
- amendments to the governing documents, including investment and shareholders' agreements and AoA, usually require unanimous or qualified majority consent, depending on existing contractual arrangements.

The overall transaction timeline, from term sheet to closing, typically ranges between eight and 12 weeks, but may extend further in transactions involving foreign investors or detailed due diligence.

3.3 Investment Structure

While *"common stock"* is used in some early-stage transactions, Polish VC practice frequently involves offering alternative instruments to investors. These include:

- preferred shares, offering rights such as liquidation preference, and veto or enhanced voting rights on key decisions;
- convertible instruments, such as CLAs, widely used in pre-seed and seed rounds to delay valuation setting. CLAs often carry interest, a discount on conversion and a valuation cap;
- founder vesting mechanisms, including reverse vesting or share buy-back rights upon founder departure; and
- put options, used selectively to provide exit rights or downside protection in distressed scenarios.

The legal enforceability and structuring of these instruments may vary depending on the company's legal form. For instance, limited liability companies face certain limitations on issuing preferred shares and may require creative structuring or conversion to a joint-stock company (*spółka akcyjna*) to accommodate more sophisticated investor rights.

3.4 Documentation

The core documentation in a Polish VC financing round typically includes:

- an investment agreement – setting out the key commercial terms of the transaction, including the amount of capital being invested, the type and number of shares to be issued, payment terms, conditions precedent to signing, warranties and post-closing obligations;
- a shareholders' agreement (SHA), which governs investor rights, corporate governance, exit mechanisms and restrictions on share transfers (lock-ups, rights of first refusal), and anti-dilution protection – this remains the principal document setting out the relationship between the parties;
- the AoA, amended to reflect the issuance of new shares, the new capital structure, and any new corporate governance and investor rights, and filed with the public register;
- relevant corporate resolutions, including a notarial resolution of the shareholders' meet-

ing adopting the capital increase and AoA changes; and
- ancillary documents, such as disclosure letters, consent waivers, side letters and registers of shareholders.

There is no standardised template commonly used across the Polish VC ecosystem. Documents are typically prepared on a bespoke basis, using law firm precedents or adapted from prior transactions. Market terms are generally aligned with European practice, but always negotiated individually depending on the investor profile, the public funding components and the complexity of the round. Several Polish VC funds also maintain their own investment documentation models, which serve as starting points for negotiations.

3.5 Investor Safeguards

VC investors in Poland typically negotiate a range of protections for downside scenarios, including:

- liquidation preferences, often 1x non-participating, entitling investors to the return of their original investment amount before proceeds are distributed to common shareholders;
- anti-dilution protections, typically based on the weighted-average method, with full-ratchet clauses used sparingly;
- pre-emption rights on new share issuances to preserve their ownership percentage, often paired with rights of first refusal and tag-along rights on secondary sales;
- put options/redemption rights, occasionally used to secure investors rights to sell their shares under specific conditions;
- information rights, including access to regular financial and operational updates, financial statements and business plans; and
- reserved matters, a defined list of strategic or fundamental decisions that cannot be taken without the consent of a specified majority of investors (eg, capital increases, M&A, dividend policy).

Recent market conditions have led to stronger investor positions, particularly in down rounds, with stricter milestone conditions, board seat rights and enhanced governance levers.

3.6 Corporate Governance

VC investors in Poland typically exercise governance influence through contractual rights set out in the SHA and their position as shareholders under the AoA. While the SHA establishes a private contractual framework for investor protection, key governance provisions are often reflected in or incorporated into the AoA to ensure legal enforceability against the company and third parties, in accordance with Polish corporate law.

Common mechanisms include:

- a list of reserved matters, requiring investor consent before the company can take certain actions. These typically cover new share issuances, debt financing, changes to the business model, core asset disposals or dividend distributions;
- the right to appoint a member of the supervisory board or observer to the supervisory board, which is more common in later-stage or institutional rounds.
- individual rights under the SHA, granted to specific investors or investor classes, including veto rights or enhanced information access; and
- in specific cases, especially in distressed or turnaround situations, investors may negotiate the right to nominate or approve a member of the management board to act as CFO.

Day-to-day management remains with the management board, but strategic oversight by investors through the mechanisms above is a recognised and expected feature of Polish VC transactions.

3.7 Contractual Protection

Key representations and warranties are provided by the company and often also by the founders. They typically cover:

- authority and corporate structure;
- cap table and share capital accuracy;
- IP ownership;
- compliance with law and regulatory matters;
- tax matters;
- contractual relations;
- employment and social security compliance; and
- absence of undisclosed liabilities or litigation.

Founders and the company, when providing representations and warranties, often assume liability on a guarantee basis – meaning they are liable regardless of fault – subject to contractually agreed caps. Such liability is typically capped at the amount of the investment round and time-limited, with survival periods generally ranging from 24 to 36 months following completion. Certain fundamental warranties, such as those relating to title, authority and tax matters, may survive for extended periods, commonly up to six years.

Where multiple parties provide representations, liability is frequently structured as joint and several, allowing the investor to pursue claims against any or all of the warrantors for the full amount of any loss.

Covenants and undertakings often include:

- non-compete and non-solicitation obligations;
- information undertakings;
- a requirement for founders to continue working full-time or to serve as members of the management board; and
- restrictions on dividends and shareholder loans.

While formal W&I insurance is rare in Polish VC, the framework for contractual recourse is well developed and increasingly standardised.

4. Government Inducements

4.1 Subsidy Programmes

Please see **2.4 Particularities**. Government-backed VC funds play a central role in the Polish VC market and are highly active across all stages of company development.

One of the key frameworks currently in operation is the FENG programme, funded through national and EU structural funds. It is designed to co-finance VC funds that invest in innovative Polish SMEs and early-stage companies.

The main features include the following:

- capital commitments to VC funds are made by PFR Ventures, acting on behalf of the PFR;
- the public investor typically participates under the same terms as private LPs, with pari passu investment conditions;
- investment amounts vary, but public capital generally contributes between 50% and 80% of a fund's total commitments;
- eligible funds must invest in companies registered or operating in Poland that have a

demonstrable Polish nexus, with innovation or R&D alignment; and
- financing is limited to equity or quasi-equity instruments, such as share subscriptions or convertible instruments.

These mechanisms are designed to de-risk private investment and catalyse early-stage capital formation, particularly in verticals prioritised by national innovation policy.

4.2 Tax Treatment

Investments in Polish growth companies benefit from specific tax incentives, particularly through structures like the ASI structure. These rules are governed by the Act on Corporate Income Tax (*Ustawa o podatku dochodowym od osób prawnych*). Key tax advantages include:

- *Capital gains tax exemption:* An ASI can be exempt from corporate income tax on profits from the sale of a target's shares, provided that it has held at least 5% of the shares in the company for a minimum of two years.
- *Dividend tax exemption:* Dividends received by an ASI are exempt from tax if the ASI holds at least 10% of the shares in the distributing company for at least two years, applicable when the distributing company is a tax resident of Poland, the EU or the EEA.

These incentives are designed to promote long-term investments in innovative enterprises and align with broader EU directives on investment funds.

Beyond these ASI-specific exemptions, there are no dedicated tax reliefs for VC investors or start-up companies in Poland. Income from equity investments is generally taxed in line with standard corporate or personal income tax rules, depending on the investor type.

As a result, some mature funds and scale-up companies opt to relocate their holding or fund structures to jurisdictions offering more favourable tax treatment, such as Luxembourg or the Netherlands. This trend reflects broader efforts to optimise cross-border capital flows and post-exit taxation.

4.3 Government Endorsement

Please refer to **4.1 Subsidy Programmes** and **2.4 Particularities**.

While there are no standalone nationwide campaigns or legislative packages explicitly aimed at promoting equity financing, the Polish government supports VC primarily through institutional co-investment frameworks and public fund-of-funds programmes.

One area of growing interest is corporate venture capital. Several state-supported initiatives have encouraged large domestic enterprises to establish dedicated investment vehicles for start-up engagement. These efforts are partially modelled on European strategies and reflect broader policy goals of fostering innovation through industry collaboration.

In addition, government institutions continue to support the VC ecosystem by facilitating regulatory dialogue, matchmaking platforms and thematic funding calls, particularly in sectors aligned with national innovation priorities.

5. Employment Incentives

5.1 General

Founders' and key employees' long-term commitment is typically secured through equity-based incentive mechanisms, most notably management or employee stock option plans

(MSOPs or ESOPs) or similar contractual arrangements. These structures aim to align the interests of the management teamwith those of shareholders by providing access to the company's equity upside, contingent on continued involvement and performance.

In Poland, such plans are commonly implemented as part of or alongside VC investment rounds. While there is no statutory ESOP regime, tailored contractual frameworks are frequently adopted to reflect vesting schedules, exercise conditions and transfer restrictions. Importantly, in joint-stock companies or simple joint-stock companies, ESOPs can benefit from tax-neutral treatment at the moment of grant or exercise, provided that certain statutory conditions are met. This makes these legal forms particularly conducive to implementing standardised and tax-efficient employee incentive schemes.

In most cases, ESOPs are time-based with a standard cliff and a linear schedule over three to four years. Exit-linked acceleration clauses are also common, particularly in later-stage rounds.

5.2 Securities

The legal instruments used to implement employee incentive plans in Poland depend heavily on the company's corporate form, which significantly influences the available structuring options.

- In limited liability companies, which constitute the vast majority of early-stage Polish start-ups, formal share options are not easily implementable due to rigid capital structure rules. As a result, companies often implement a virtual stock option plan (VSOP). Under such a plan, participants are granted contractual rights in the form of phantom options (cash-settled instruments mimicking share value growth) or contractual bonus entitlements (performance- or time-based bonuses linked to company valuation or exit events). These instruments do not constitute actual share ownership and do not entitle participants to voting rights, dividends or other shareholder privileges, but are designed to replicate the economic effect.
- In joint-stock companies or simple joint-stock companies, the legal framework permits more direct equity-linked incentives, such as subscription warrants or options for shares, which entitle employees to acquire shares at a fixed price (strike price) upon meeting certain vesting or performance conditions. These instruments can be structured to reflect vesting and exercise conditions and are more closely aligned with international VC practice.

Regardless of form, incentive instruments typically include:

- vesting provisions, with time- or milestone-based criteria;
- exercise rights, often triggered by liquidity events; and
- restrictions on transferability, embedded either in the option documentation or in the SHA.

VC investors typically expect the ESOP to be reflected in the fully diluted capital structure and factored into ownership calculations at the time of investment, even if the plan itself is implemented post-closing. The agreed-upon option pool (commonly 5–15% of the share capital) is treated as a pre-investment dilution item, effectively reducing the founders' and early shareholders' equity share upfront.

5.3 Taxation of Instruments

The tax implications of employee incentive instruments in Poland depend on the nature of the instrument and the participant's employment status:

- *Employment contract (umowa o pracę):* Benefits derived from ESOPs are typically treated as income from employment and subject to standard personal income tax rates, along with social security contributions. However, in qualifying programmes implemented by joint-stock companies or simple joint-stock companies, taxation may be deferred and assessed as capital gains, provided statutory conditions are met.
- *B2B contract:* For individuals engaged under business-to-business contracts, the taxation depends on their chosen form of taxation (eg, linear tax, progressive tax or lump-sum tax). It is essential for participants to consult with tax advisers to understand the specific implications, because tax liabilities may differ significantly depending on how the benefit is structured.

The taxable event generally arises when the beneficiary monetises the shares, ie, at the moment of sale rather than at grant or exercise – assuming the ESOP is implemented in accordance with the requirements of the Personal Income Tax Act (*Ustawa o podatku dochodowym od osób fizycznych*). Otherwise, income may be recognised earlier and taxed as employment income.

5.4 Implementation

The implementation of an employee incentive plan is typically addressed in parallel with the negotiation and closing of a financing round. While not always adopted at the same time, the plan is usually pre-agreed in principle and documented in the transaction package through a contractual commitment to implement within a defined timeframe.

From a legal perspective, the decision to establish an incentive scheme does not always require a formal resolution of the shareholders' meeting. However, where the company intends to rely on the tax preferences available under the Personal Income Tax Act, such a resolution is typically required. In practice, most schemes are either formally approved by shareholders or embedded in the SHA, with allocation ranges commonly set between 5% and 15% of fully diluted share capital.

The economic burden resulting from the incentive pool is generally shared among all existing shareholders pro rata. However, depending on the negotiation dynamics, this dilution may be pre-emptively factored into the capitalisation table at closing, thereby neutralising its effect on post-money investor ownership.

Where the plan is not formally adopted at the time of closing, the company is often contractually obliged to carry on its implementation. VC investors commonly require such undertakings to ensure the enforceability and timely activation of the incentive mechanism.

6. Exits

6.1 Investor Exit Rights

Exit-related provisions in Polish venture transactions follow widely recognised international standards, albeit with some local distinctions based on company form and transaction size. The most commonly negotiated rights include:

- tag-along rights, enabling minority shareholders to participate proportionally in a sale

by the majority (see also **3.5 Investor Safeguards**);
- drag-along rights, allowing a majority shareholder or a designated investor majority to compel minority shareholders to sell on the same terms, facilitating trade sale exits;
- right of first refusal and right of first offer, protecting existing shareholders against unsolicited transfers of equity;
- contractual put options, typically exercisable after a defined period or in case of default events (see **3.5 Investor Safeguards**); and
- lock-up periods, particularly where an IPO or structured liquidity is contemplated, though rarely tested in practice in Poland.

The concept of an *"exit trigger"* is usually defined by reference to specific events such as a trade sale, change of control, or strategic acquisition. These are envisaged in the SHA and may be tied to investor majority thresholds or milestone-based acceleration clauses.

Given the scarcity of liquidity events in the Polish VC ecosystem, market practice has evolved to include partial secondary exits, enhanced drag mechanics and strong information rights in preparation for eventual disposals. In some cases, contractual exit timelines (eg, five to seven years post-closing) are agreed to reinforce exit discipline, though enforcement remains rare.

6.2 IPO Exits

IPO exits remain exceptionally rare in the Polish start-up environment and are not regarded as a standard route to liquidity for VC-backed companies. In 2024, no venture-backed start-up completed an IPO on the Warsaw Stock Exchange, and no such listings were actively planned.

Instead, the dominant form of exit continues to be trade sales, typically structured as share deals, with exits involving strategic acquirers or private equity funds.

The Polish capital market remains immature for VC-backed listings, with limited analyst coverage, insufficient scale and a fragmented investor base. Companies seeking public capital typically consider foreign exchanges – primarily in the EU – once they reach sufficient maturity, scale and governance readiness. However, such transitions remain uncommon at present.

6.3 Pre-IPO Liquidity

Please refer to **6.2 IPO Exits**. As IPOs are not a realistic exit path for VC-backed companies in Poland, structured pre-IPO liquidity programmes – including employee share tenders, secondary blocks and managed liquidity events – remain largely theoretical in practice.

There is no active secondary market infrastructure or legal framework specifically supporting structured liquidity prior to listing. Informal secondaries do occur, typically negotiated privately and with consent under SHA restrictions (see **3.5 Investor Safeguards**). Company-facilitated tender offers are rare and tend to be limited to corporate governance clean-ups or founder realignments.

As the market matures, greater use of structured secondaries may develop, but for now, liquidity remains tightly linked to full trade sale events.

7. Regulation

7.1 Securities Offerings

In Poland, VC transactions involving equity securities are primarily governed by the Polish

Commercial Companies Code (*Kodeks spółek handlowych*) and, where relevant, the Act on Public Offering (*Ustawa o ofercie publicznej*). Most venture financings are structured as private placements and are therefore not subject to prospectus or registration requirements, provided that the offering does not qualify as a public offering under local law.

Instruments issued to employees or key personnel, particularly in joint-stock structures, may include subscription warrants, provided they are authorised by the company's governing bodies and registered accordingly. These instruments are typically used in the context of incentive schemes. Please see **5.2 Securities** for further details regarding the use of such instruments in employee incentive plans.

Convertible bonds and other hybrid instruments are generally not used in Polish financing practice.

7.2 Restrictions

Certain sectors defined as strategic – such as defence, energy, telecommunications and critical infrastructure – are covered by specific legal frameworks, including the Act on Control of Certain Investments (*Ustawa o kontroli niektórych inwestycji*). This legislation provides for screening mechanisms intended to prevent the acquisition of controlling stakes in companies of systemic importance by non-EEA or non-OECD investors. However, these provisions are not typically applicable to VC investments, as they relate to large-scale infrastructure and utility projects rather than early-stage companies.

Additionally, Poland has implemented sanctions in line with EU regulations, restricting investments from entities associated with certain countries, including Belarus and Russia. These measures aim to safeguard national security and public order.

From a compliance perspective, foreign investors must adhere to anti-money laundering and know-your-customer requirements. This includes registration in the Central Register of Beneficial Owners (*Centralny Rejestr Beneficjentów Rzeczywistych*) and, for joint-stock companies and simple joint-stock companies, maintaining a shareholder register, which may be managed by a notary or a brokerage house.

Trends and Developments

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Market Overview

The Polish venture capital market has continued to evolve over the past 12 months, maintaining resilience in a global environment marked by capital tightening, subdued exit markets and investor caution. While the number of transactions has decreased somewhat compared to previous years, overall activity has been stable, with investment volumes concentrating around more promising and well-prepared early-stage companies. Rather than signalling a broader shift towards later-stage transactions, this trend reflects growing selectivity among investors who are prioritising capital efficiency, product-market fit, and strong founder teams.

Several structural features continue to shape the Polish VC landscape. The majority of investments were directed towards early-stage and seed rounds, reflecting the strength of Poland's founder pipeline and the central role of public capital mechanisms in supporting first-time institutional capital. Notably, the market is currently navigating a transitional phase between funding frameworks, as vehicles backed under the POIR (*Program Operacyjny Inteligentny Rozwój*) framework turned into divestment phase and new funds selected under the EU's FENG (*Fundusze Europejskie dla Nowoczesnej Gospodarki*) programme begin deployment. This interim period has contributed to temporary fluctuations in capital availability and delayed some fund launches, particularly in the seed segment. However, later-stage financing remains relatively constrained and increasingly reliant on super angels, international syndicates, family offices, and private VC funds. Cross-border investment activity has remained robust, with foreign investors participating in more than half of all VC capital deployed during the period.

The ecosystem has also seen greater consolidation and professionalisation. Repeat fund managers now dominate the most active quartile of GPs, and legal and commercial terms in venture transactions are becoming more standardised and aligned with international practice. While public capital continues to anchor most early-stage activity, there is a visible push towards more thematically focused funds, sector specialisation, and alignment with EU innovation and digitalisation goals.

Overall, Poland maintains its position as one of the key innovation and venture capital hubs in Central and Eastern Europe. Continued support from public institutions, combined with growing participation from global capital, provides a foundation for cautious optimism, particularly if local exit channels and late-stage funding options expand in the coming years.

Legal Forms of Venture Capital

Alternative investment company (ASI)

The predominant legal structure for venture capital funds in Poland is the alternative investment company (*Alternatywna Spółka Inwestycyjna* ASI). This vehicle operates under the Polish Act on Investment Funds and is under supervision of the Polish Financial Supervision Authority (KNF). The ASI regime allows for both internally managed and externally managed funds and offers a relatively light-touch regulatory framework for vehicles with assets under EUR100 million.

An ASI is most commonly structured either as a limited liability company (*spółka z ograniczoną odpowiedzialnością*) or limited joint stock partnership (*spółka komandytowo-akcyjna*), with a management company holding general partner rights. While some larger or internationally oriented funds are formed under Luxembourg or

Dutch law, the domestic ASI structure remains the default for Polish VC managers.

Key legal documents

Every fund structured as an ASI is governed by two foundational sets of documents:

- The articles of association (AoA) is filed with the National Court Register and define the fund's corporate governance, including share capital, management authority, and decision-making thresholds. In the case of partnerships, equivalent provisions are included in the partnership deed.
- The limited partnership agreement (LPA) or, where applicable, the shareholders' agreement (SHA), serves as the primary contractual framework between the investors, the general partner, and fund. These documents cover matters such as capital commitments, drawdown procedures, management fees, carried interest mechanisms, transfer restrictions, and dispute resolution clauses.

In recent years, Polish fund documentation has become increasingly harmonised with international standards. This has improved transparency, enhanced investor protections, and facilitated cross-border collaboration and co-investment with international partners.

Focus on Emerging Sectors: AI and Defence

A defining feature of the past 12 months has been the rapid emergence of artificial intelligence and dual-use defence technologies as emerging sectors for VC activity. Polish technical talent in these areas has drawn attention from leading global investors, often resulting in oversubscribed seed and Series A rounds.

AI

Companies such as Wordware (developer productivity tools), Kick (AI-native fintech platform for accounting automation), and ElevenLabs (voice synthesis) closed major rounds, frequently led by international VCs and structured offshore. While deal execution often takes place outside of Poland, core R&D, engineering and product teams remain locally based, demonstrating the country's comparative advantage in deep-tech execution.

VC interest in AI-related ventures intensified across multiple verticals. In 2024 alone, nearly 50 transactions involved companies building or meaningfully deploying artificial intelligence solutions. Total investment volume in the sector exceeded EUR250 million, with approximately EUR46 million directed specifically to start-ups developing foundational AI tools.

Defence

In parallel, the regional geopolitical context – most notably the war in Ukraine – has catalysed interest in defence-aligned ventures. Investors have begun to allocate capital towards aerospace, autonomous systems, real-time analytics and dual-use infrastructure. Although still an emerging category, the segment is expected to attract greater institutional attention, particularly as NATO-aligned procurement and sovereign VC activity expand across the EU. In Poland, this trend is reflected in the establishment of the Polish Defence Fund – a EUR100 million initiative aimed at supporting innovation in defence and dual-use technologies. Backed by state-linked institutions including the Ministry of National Defence, Bank Gospodarstwa Krajowego (BGK), Polska Grupa Zbrojeniowa (PGZ), and MS TFI, the fund is expected to launch ahead of the NATO summit in mid-2025. Additionally, a new programme, PFR Deep Tech, was announced in

May 2025 with a total capitalisation of EUR140 million. The initiative is a joint effort of Poland's Ministry of Finance, the Polish Development Fund (PFR) and PFR Ventures. It is designed to support investment in advanced technologies such as robotics, cybersecurity, quantum and space technologies, with particular emphasis on dual-use applications. The capital will be allocated to three to five specialised VC funds, with the aim of financing 50–80 projects developing deep tech solutions.

Transactional Trends and Structuring

Transactional practice in Poland has evolved considerably, particularly at the later stages of the investment life cycle. Shareholders' agreements (SHAs) have become increasingly detailed, reflecting both investor protections and founder alignment provisions. These agreements now incorporate a range of contractual tools to balance risk and incentives for all parties involved.

Key features now typically include:

- weighted-average anti-dilution protection, which adjusts the investor's share price downward in future dilutive rounds, providing economic protection if shares are issued at a lower valuation;
- 1x non-participating liquidation preference, granting investors the right to receive their original investment before any proceeds are distributed to common shareholders, without further participation in upside;
- drag-along and tag-along rights, which respectively allow majority shareholders to compel minority holders to sell in an exit event and permit minority holders to join in a sale on the same terms;
- reserved matters, requiring investor consent for critical corporate actions such as changes to share capital, business scope, or M&A transactions; and
- governance rights, including the right to appoint a supervisory board member or observer and receive regular financial and strategic reporting.

Convertible instruments such as convertible loan agreements (CLAs) have gained popularity in early-stage and bridge financing transactions. These allow investors to inject capital on a short timeline while deferring valuation negotiation.

VC rounds are still predominantly closed in the form of capital increases within limited liability companies (*spółka z ograniczoną odpowiedzialnością*), which remain the most commonly used legal vehicle for start-ups. These transactions typically require notarial resolutions and subsequent registration with the National Court Register (KRS).

Due diligence processes have also become more efficient. While still limited in scope compared to private equity transactions, they typically cover key areas such as cap table structure, intellectual property ownership, financing documents, and any public aid received. This phase of the process usually lasts between six and eight weeks and is conducted on a red-flag basis, enabling a faster path to signing while flagging key legal risks for negotiation.

The Role of Public Capital

One of the most defining characteristics of the Polish venture capital market is the active presence of the public sector, not only as a passive backer but as a strategic architect of the local fund environment. Unlike in many Western jurisdictions where LP capital is primarily institutional or private, in Poland public actors remain critical to both fund formation and deployment.

The key actors in this landscape include PFR Ventures, the VC arm of the Polish Development Fund, NCBR (the National Centre for Research and Development), and BGK (the Polish Development Bank). Each of these institutions operates targeted co-investment and support schemes which form the financial foundation of many VC funds. These public entities do not act as direct investors in start-ups but instead serve as limited partners in privately managed funds, using structured calls and allocation procedures to deploy capital across the ecosystem.

Dedicated funding lines such as Bridge VC (NCBR), CVC, Koffi, Biznest, and Starter (PFR) have financed dozens of funds over the past several years. Public capital provided through these schemes can constitute up to 80% of a fund's total commitments, often requiring the GP to raise the remainder from private or institutional sources. Participation in these schemes imposes obligations on fund managers, such as investing within designated geographic areas, targeting SMEs, or prioritising sectors of strategic importance (eg, R&D, green energy, AI, or HealthTech).

The result is a two-speed market: a first tier of funds backed by public LPs operating under programme mandates, and a second tier of more independent vehicles, typically launched by managers with a proven track record under the former model. This staged development strategy has supported capacity-building among local GPs and led to a more structured, disciplined approach to capital allocation.

The thematic focus of public capital has also become more pronounced. Increasingly, public calls are structured not only by stage or geography, but by sector. Healthtech, industrial automation, defence dual-use, ESG-aligned ventures and AI-based solutions are all examples of areas prioritised by public LP programmes in recent years. This in turn shapes the pipeline of companies receiving funding and indirectly nudges the sectoral profile of the Polish start-up economy.

A pivotal development in 2025 will be the allocation of capital under the new FENG framework (*Fundusze Europejskie dla Nowoczesnej Gospodarki*), the successor to earlier EU funding instruments. Several newly established VC funds received commitments under this scheme and are now entering their deployment phase. This new wave of funds is expected to play a major role in rejuvenating seed and early-stage capital availability and in encouraging more specialist, vertical-focused investment strategies.

The public sector remains the dominant source of early-stage VC funding in Poland and continues to shape the priorities and structure of the local fund market.

Exit Environment and Liquidity Constraints

Liquidity remains one of the most significant structural challenges facing Polish VC. Despite a maturing ecosystem and improved deal quality, the number of high-profile exits remains limited. Over the past 12 months, there were no venture-backed IPOs on the Warsaw Stock Exchange or its SME segment, NewConnect (a dedicated market for smaller and growth-stage companies). Instead, trade sales continued to dominate exit strategies, primarily through secondary share transfers to private equity or strategic buyers.

Exit volumes have remained relatively flat compared to 2022–2023, and although the market saw a few notable outcomes, such events were more the exception than the rule. It is generally considered that the ecosystem still lacks the

kind of repeatable, high-return exits that draw sustained interest from global LPs and late-stage capital providers.

The market continues to mature, but industry consensus suggests that the long-term credibility of the Polish VC ecosystem will depend on the emergence of a more predictable and visible exit pipeline. Until then, trade sales and partial secondary transactions will likely remain the dominant path to liquidity for VC-backed companies.

Outlook and Strategic Positioning

The Polish venture capital market is entering a more mature phase, characterised by gradual internationalisation, moderate specialisation, and increasing legal and operational alignment with international norms. While key building blocks are in place, such as a technically skilled founder base and active public LP support, the market continues to face persistent challenges around late-stage capital, repeatable exits, and cross-border fund structuring.

Looking ahead, the ecosystem is expected to stabilise around a dual model: one segment driven by domestic, publicly anchored early-stage vehicles, and another increasingly integrated into global syndicates and scale-up funding networks. Legal structures are also diversifying, with a growing number of managers choosing to domicile funds abroad to meet institutional investor standards.

Poland's long-term position will depend not only on capital availability but also on exit scalability and the professionalisation of GP platforms. If market maturity continues on its current path, Poland is well-positioned to serve as a leading Central European node for growth-stage venture investment.

PORTUGAL

Law and Practice

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1. Trends

1.1 VC Market

The most sizeable financing rounds in Portugal in 2024 were:

- 360imprimir, which raised EUR18 million;
- Campicarn, which raised EUR6.4 million;
- Visor.ai, which raised EUR4.4 million;
- Kencko, which raised EUR4.1 million; and
- HiJiffy, which raised EUR3.8 million.

1.2 Key Trends

The last 12 months were heavily shaped by seed and series A financing rounds aimed at research and development activities made by SIFIDE funds. Access to funding, other than for R&D activities, has been steadily decreasing, contributing to an investors' rather than a founders' market. In response to this trend, Portugal's information technology industry has been rapidly growing, as seen by the large number of new start-ups investigating this field. The number of exits was below what was expected as a result of poor market conditions. For this reason, and as explained later in this chapter, the trend of the creation of continuation funds has been increasing. Start-ups are closely monitoring the market for opportunities to grow by acquisition to ramp up their metrics. Furthermore, 2024 was marked by the trend of incorporation of Portuguese R&D subsidiaries from foreign start-ups, in search of funding. Secondaries from founders have become rarer.

1.3 Key Industries

It is hard to pinpoint specific industries which drove VC activity when most of the Portuguese investment funds are agnostic, notwithstanding banking and finance, insurance, cybersecurity and data-driven industries which are more favourable to investment. Additionally, it is important to mention that as a response to the SIFIDE investment trend mentioned in **1.2 Key Trends**, target companies have been increasingly focused on developing innovative technology-based products.

2. Venture Capital Funds

2.1 Fund Structure

VC funds in Portugal are organised as closed-end VC funds and are subject to specific regulation (see **2.3. Fund Regulation**).

The applicable regime requires these funds to have a limited partnership agreement, whereby the management entity of the fund outlines the rights, obligations and corporate governance of the fund. This document also covers the following matters: investment policies and strategies, capital contributions, profit sharing, decision-making processes and exit strategies.

The investors who wish to subscribe to participation units in the VC funds shall enter into a subscription agreement that will detail the terms and conditions of their investment, the committed capital, the number of participation units being subscribed, how the payment will be made and the type of participation units.

These documents, along with regulatory filings, disclosures required by the Portuguese Market Commission (CMVM) and compliance with anti-money laundering regulations, form the legal and operational framework governing the operation and management of VC funds in Portugal.

2.2 Fund Economics

In Portugal, there are a couple of common practices and structures that allow the fund's managers to participate in the economics of the VC

fund, as detailed below (Management Fees, Carried Interest, Hurdle Rate, Co-Investment and Conflict of Interest policies). However, these structures need to be evaluated on a case-by-case basis because in Portugal, as in many other jurisdictions, fund managers owe fiduciary duties to the investors in the funds they manage. These duties are based on principles of trust, loyalty and good faith, and require fund managers to act in the best interest of the fund's investors, and not in their own.

Management Fees

The fund managers receive management fees, which are annual fixed fees charged as a percentage of the value of the total assets of the respective fund. These fees cover operational expenses, salaries and other costs associated with the management of the fund.

Carried Interest

Another common practice is to establish that, upon liquidation and after the distribution of profits to the fund's participants, a percentage of the earnings will be paid to the fund's managers.

Hurdle Rate

Together with the carried interest, a hurdle rate is usually established. The hurdle rate sets the minimum rate of return that the fund must achieve so that the fund managers can receive the carried interest.

Co-Investment

Lately, the possibility of co-investment – ie, the fund's founding participants and the fund managers having the possibility to, upon verification of certain conditions (including, but not limited to, investment amount, stage of the target, amount of the ticket, target activity), invest alongside and under the same terms and conditions of the fund has become more popular.

Conflict of Interest Policies

Simultaneously with the above – and as an outgrowth of the fiduciary duties – the funds need to have conflict of interest policies, which are made in order to identify, manage and mitigate conflicts that may arise between the interests of the fund managers, or related parties, and those of the fund's investors.

2.3 Fund Regulation

VC funds are highly regulated in Portugal and need to follow the Asset Management Regime (*Regime de Gestão de Ativos* or RGA) and the entity responsible for the regulatory oversight is the CMVM. The CMVM is responsible not only for approving the registration and incorporation of VC companies and VC funds, but also for overseeing the operation and activities of those entities.

Compliance with the aforementioned regime (both in the registration stage and in the day-to-day management) is essential for VC entities operating in Portugal to maintain legal and operational legitimacy.

2.4 Particularities

On the one hand, VC investment in Portugal has some particularities due to key aspects, such as the programmes established by the government to boost entrepreneurship. An example is *"Consolidar"*, a programme with an overall budget of up to EUR500 million, which aims to support the subscription of VC funds for investment in SMEs and mid caps. However, this programme still has some limitation regarding the fund's investment policy, where the investments can be made and the type of instruments that the fund can subscribe. In addition, the EU funding of VC funds, the tax incentive system for research and development (SIFIDE) depends on the target companies being classified by the Portuguese

Innovation Agency (ANI) as R&D companies, and creates additional layers of governance rights and reporting obligations.

Moreover, the trend of co-investment has been adopted by government-backed funds, through the programme *"Coinvestimento Deal-by-Deal"*, which has a EUR200 million budget and emphasises innovation and sustainability. 2024 was also marked by the creation of the Venture Capital programme by Banco Português do Fomento, with a EUR400 million budget. Under this initiative, the bank invests in Portuguese venture capital funds, which in turn are expected to invest in early-stage start-ups during the first months of 2025. Lastly, in terms of the ecosystem itself, the presence of VC investments in Portugal has been growing and evolving over the past decade, with increasing activity in start-up funding (from Portuguese and foreign investors) and the creation of incubators and accelerators (like StartUp Lisboa, StartUp Braga, Startup Leiria, and Fábrica de Unicórnios).

On the other hand, given current market conditions, venture capital investment in Portugal now often requires longer holding periods. One such approach is the establishment of continuation funds, which enable investors to exit under more favourable terms than they might achieve at the original maturity date of the fund. Additionally, because SIFIDE investments typically impose a minimum holding period of four years, investors are increasingly seeking a more active role in portfolio companies. This is often reflected in requests for board seats, observer rights, and enhanced reporting obligations to ensure closer involvement in the company's day-to-day operations.

3. Investments in Venture Capital Portfolio Companies

3.1 Due Diligence

VC fund investors typically carry out legal, tax, financial, technical and (more recently) behavioural due diligence.

The legal due diligence is usually conducted on *"red flag"* basis, focusing on corporate structure, assets, financial aspects, key contracts, insurance, labour, intellectual property, technology, data protection, regulatory matters and litigation.

The tax and financial due diligence are often carried out by financial consultants.

The technical due diligence aims to validate the existence of the technology and its state of the art.

Behavioural due diligence aims to assess and establish the founders' ability to tackle the challenges of a fast-paced, high-octane, and aggressive environment.

3.2 Process

The timeline of a new financing round, such as a Series A financing round, with new anchor investors, can vary significantly, typically ranging from one to six months. This variation depends on several interrelated factors, including the scope of due diligence, the complexity of the deal structure, the negotiation of terms and conditions, the mix and interests of existing versus new investors, and the drafting and finalisation of legal documentation.

Factors Affecting the Timeline

There are a number of factors that may affect the timeline.

- Due Diligence: The extent of information provided by the company and the complexity of the company's structure, operations and contracts might delay the timeline.
- Negotiation of Terms and Conditions: When the company does not consider the market conditions and the rights attached to the financing and the involvement of the legal counsel is delayed, that could also create some delays in the deal.
- Compliance with Regulatory Requirements: The need to obtain certifications or to confirm the eligibility criteria usually creates a delay in the timeline.
- Existing Versus New Investors: Potential conflicts may arise due to different visions or policies. Usually, the company and its counsel deal with the existing investors, and the new anchor investors hire a joint counsel to mitigate the conflicts between the parties and create some efficiency in the negotiations. When the company requires additional efforts to co-ordinate different parties, the timeline is normally extended.
- Majority Requirements Versus Consents By the Existing Investors: The default rule in Portugal is the simple majority for the approval of business/day-to-day decisions. However, fundamental changes, such as amendments to the articles of association, creation of a new class of shares with special rights and changes impacting rights attached to shares usually require the consent of the existing investors and, if existing investors and new investors are not in synch, all this can create additional layers of complexity and potentially lead to delays in completing the financing round.

3.3 Investment Structure

Early-stage financing in Portugal is typically carried out through equity financings or convertible instruments.

Funding through equity financing often means that the company will issue the investors preferred shares, which are a type of share that carries certain preferential rights not available to common shareholders. These rights usually include:

- non-participating liquidation preferences;
- anti-dilution protections ((i) and (ii) further detailed in **3.5. Investor Safeguards**);
- pre-emptive and follow-on rights;
- restrictions on the transfer of founders' shares – such as lock-ups and reverse vesting mechanisms;
- exit mechanisms – such as the tag-along right, the drag-along right and the mandate to sell (further detailed in **6.1. Investor Exit Rights**);
- governance rights (further detailed in **3.6. Corporate Governance**);
- voting rights and the creation of qualified majorities for certain resolutions of the general meeting; and
- information rights – arising out of the reporting obligations that the investment fund might have towards the Portuguese regulator, the CMVM, or due to their particularities as government-backed funds or SIFIDE funds.

At a very early stage, where the valuation is not yet defined and the company needs urgent funding, the convertible instruments take the lead.

Convertible instruments, which usually vary between convertible loan agreements (CLAs) and simple agreements for future equity (SAFEs), are instruments designed to provide a very

straightforward way for investors to invest in the company.

CLAs are classified as debt instruments where the principal amount, upon verification of certain triggering events, can be converted into a predetermined category of shares or reimbursed. CLAs usually accrue interest and have a maturity date.

Investors, for as long as they hold the CLA, will not be shareholders and, as a result, will not have the rights attached to shares. However, if the investor is an institutional investor, the information rights are usually granted.

Once the CLA converts into shares, the investor that subscribed for the CLA will have the rights of the class of shares to which the CLA converts – usually the same shares as the investors in an equity financing, if the CLA converts due to an equity financing, or a new category of shares, with the same special rights of the shares of the previous round which shall rank senior to those shares.

On the other hand, there are SAFEs, which are instruments introduced by Y Combinator. This instrument is very similar to a CLA as regards its conversion terms and conditions, with the exception of the following:

- It shall be considered as other equity instruments.
- The principal amount shall not be reimbursed.
- It shall not accrue interest.

In Portugal, in contrast with the UK and the USA, most investors are institutional funds and a maturity date is usually required for the conversion of the SAFEs into equity.

3.4 Documentation

Portuguese financing rounds are typically investments in equity (as set out in **3.3. Investment Structure**), where the typical key documents are a term sheet, containing the main terms and conditions of the investment, followed by the so-called long-form documents, which are the investment and the shareholders agreements.

Financing rounds based on convertible instruments are also very common in Portugal, and in these rounds – depending on the amount and on the type of investors – the long-form documents used are SAFEs or CLAs and shareholders agreements.

Portugal has not yet reached (and is far from reaching) the level of standardisation of the USA and the UK (since Portugal does not have guidelines like NVCA), but experienced lawyers and players in the VC area of practice have been increasingly trying to standardise clauses and rights by following international standard practices.

3.5 Investor Safeguards

To protect their investment in a downside scenario, VC investors in Portugal usually include some clauses that simultaneously protect their investment and prioritise their return of capital, the anti-dilution protection and the liquidation preference.

Anti-Dilution Protection

Anti-dilution protections are commonly used by VC investors to protect their ownership stake and economic interest in the event of a future down round (an issuance of shares at a lower price per share than the one paid by the relevant VC investor). The broad-based weighted average is the most common anti-dilution protection

but, in some scenarios, a full ratchet anti-dilution protection may also apply.

As opposed to what happens in other jurisdictions, where the anti-dilution works as an adjustment to the conversion ratio of preferred shares into common shares, in Portugal it usually works as an automatic mechanism where, simultaneously with the down round, the company makes a compensatory capital increase (through the conversion of reserves or at the nominal value).

Liquidation Preference

VC investors also require a liquidation preference which entitles them to receive, before the other shareholders, at least an amount of proceeds from the liquidity event equal to the amount of their investment.

In the event that more than one VC investor is entitled to a liquidation preference at an equal level and the proceeds are not sufficient to completely fulfil the liquidation preferences of all such entitled VC investors, the proceeds are distributed on a pro rata basis with regard to the amount of the liquidation preference at the respective level.

Participation Rights

It is common for VC investors to request participation rights in order to ensure that their stake in the company is not diluted in future investment rounds or to prevent the occurrence of a change of control. The most common provisions in this scenario are the pre-emption rights provision, which grants the investor rights over the issuance of new shares, the right of first refusal, which grants the investor rights over the sale of outstanding shares and, lastly and less often requested, the super pro-rata right, which mainly entitles investors to invest in future funding rounds beyond their current percentage.

3.6 Corporate Governance

The investors' typical influence over the affairs of the company may vary depending on the stage of the company, the size of the round, the type of investment and the invested amount, but one way or another, VC investors usually exercise influence over the management, through all or some of the following rights:

- by securing a seat on the board of the company, with a non-executive board member, that usually (alone or together with other directors appointed by the other investors) exercises its influence over key strategic decisions and has the ability to veto certain actions that may have an impact on their investment;
- by having the right to appoint an observer to attend board meetings; despite not having voting rights, observers will share their know-how, participate in discussions and be informed about the path the company is choosing; and
- by creating qualified majorities that require the approval of a certain class of shares – and sometimes veto rights – for the approval of the general meeting resolutions that can impact the rights attached to their shares and the protective provisions of their investment.

3.7 Contractual Protection

In the context of a financing round – and depending on the stage of the company – usually the company and the founders (or solely the company) will be jointly and severally liable for a breach of the representations and warranties (R&Ws).

The R&Ws can be categorised into two main types: the fundamental and the operational R&Ws.

- The fundamental R&Ws cover the company's legal status, authority to enter into the agreement and the ownership of shares, and the liability of the breaching party to these R&Ws is not limited in amount nor in time.
- The operational R&Ws provide assurances to the investor regarding the current state of the company's affairs and its ability to conduct business as usual and cover the company's compliance with laws and regulations (including tax laws), the absence of pending litigation, the accuracy of financial statements, the ownership of intellectual property rights, the validity of contracts, and the absence of material adverse changes in the company's business. The liability arising from a breach of the operational R&Ws is usually limited to the amount of the investment – for the company – or to a multiple of the annual remuneration – for the founders, and is usually subject to a time limit that may vary between 12 to 36 months.

Upon a breach of the R&Ws, investors may be entitled to compensation, which can be paid in cash or shares.

Payment in cash shall be made through the delivery of a cash payment in the amount of the losses. Payment in shares shall be made through the transfer of founder's shares in the company to be converted into shares with the exact same rights and entitlements as the shares subscribed by the relevant investor, or through a compensatory share capital increase, to be fully acquired at nominal value by the relevant investor (all costs to be borne by the founders or the company), taking into consideration the pre-money valuation of the investment round in which the investor has invested in the company adjusted by the exact amount of the relevant loss.

4. Government Inducements

4.1 Subsidy Programmes

Please see **2.4 Particularities**. Government-sponsored VC funds are available and very active in Portugal.

However, the *"Consolidar"* programme is the one that creates more incentives for equity financings in Portugal. The programme has an overall budget of up to EUR500 million and supports the subscription of VC funds for investment in SMEs and mid caps.

The main features include:

- The subscription of VC funds is made by the Portuguese Recovery and Resilience Fund (FdCR).
- The FdCR will have the same investment conditions as private investors in each VC fund.
- The investment amount is between EUR10-50 million.
- The FdCR can subscribe up to 70% of the VC fund.
- The VC fund needs to invest an amount corresponding to FdCR's investment in companies registered or operating in Portugal.
- The VC fund can only invest through equity or quasi-equity instruments.

After a period of three years, the VC fund and/or the founders can buy back FdCR participation for the amount of the investment with a certain interest rate accrued.

4.2 Tax Treatment

There are specific tax rules for VC investments, or VC funds. In Portugal, for individuals, capital gains are taxed at 28% over 100% of the capital gain, or over 50% if the company is a micro/small company. Participation exemption exists if

the holding is above 10% and the participation was held for a period longer than 12 months, which is typically harmful for business angels that, in an exit scenario, are usually below the threshold of 10%. In such case, the seller subjects the capital gain to its CIT tax rate. Currently the CIT general tax rate is 21%, plus local tax. The SMEs have a reduced rate of 12.5% for the initial EUR50,000 of taxable income.

4.3 Government Endorsement

Please refer to **4.1 Subsidy Programmes** for details of government incentives. Other noteworthy initiatives are the stock options tax scheme, whereby employees of start-ups that receive stock options are subject to a single taxable event (sale of the shares), and the tax rate is reduced to 14%. Board members are excluded from this regime.

5. Employment Incentives

5.1 General

In Portugal, founders' and key employees' long-term commitment is procured through the combination of several methods that ultimately reward their performance and commitment by giving them the opportunity to share in the future success of the company – ie, upon the occurrence of trade sale, an IPO or any other liquidity event.

For such purpose, start-ups – from seed to later stages – create incentive plans to offer to their key employees (alongside their monthly remuneration).

For the founders, acting as directors, despite the possibility of them being issued rights under the incentive plan, the incentive provisions are usually specified in the shareholders' agreement. These agreements usually incorporate stricter clauses governing *"bad leaver"* and *"good leaver"* scenarios. *"bad leaver"* event typically occurs when a founder voluntarily departs the company or is dismissed for just cause, whereas *"good leaver"* is defined as a founder leaving under circumstances not constituting *"bad leaver"* event. Should a founder-director be classified as a bad leaver, the company is typically entitled to acquire both their vested and unvested shares at their nominal value. Conversely, if deemed a good leaver, the company usually retains the right to acquire only their unvested shares.

In addition to the above, non-compete, lock-ups and leaver provisions are commonly created to ensure that the founders' vision remains aligned with that of the company and, if not, there are mechanisms to reduce any losses in connection therewith.

5.2 Securities

Due to the creation of the Start-ups Law (see **5.3. Taxation of Instruments**) and the requirements created by VC investors (which, now more than ever, value and demand that plans of this kind be created as a condition for their investment), the incentive plans foreseen are in the process of standardisation. Their main features are the following:

- There must be an unallocated pool of approximately 10% of the company's share capital available to award to key employees.
- The board can grant options to key employees.
- The exercise of the options gives rise to phantom shares (which are instruments granting their owners the economic – but not the voting – rights of real shares).
- The exercise price is usually the valuation of the previous investment round.

- The exercise of the options is subject to a vesting period – usually of 48 months with a one-year cliff period – and leaver provisions aligning with the company's and the employee's long-terms objectives.
- Upon occurrence of a trade sale, an IPO or liquidity event, the employee will have the right to sell phantom shares.

5.3 Taxation of Instruments

In May 2023, a new stock options taxation regime that aims at ensuring that taxation is competitive and occurs only when the gains are effectively obtained was created.

Under that new regime:

- a 50% exemption on the gains resulting from a stock options plan was created;
- the actual taxation rate on those gains can be reduced up to 14% if securities and underlying rights are held for a minimum one-year holding period;
- the beneficiaries shall be issued securities or equivalent rights; and
- the taxation only occurs upon *"alienation"* and includes exchange of shares.

However, this new taxation regime disregards:

- the absence of liquidity in exchange of shares; and
- cash settlements, which were the market standard up to that date.

It is very important to keep in mind that the exemption created by this regime is not applicable to stakeholders with more than 20% of the share capital or voting rights of the entity issuing the stock options plan.

5.4 Implementation

Usually, when a new investor comes in, it requires the creation or the increase of unallocated pools of stock options between 7-10% of the company's share capital for future allocation to key employees.

In terms of dilution, the pre-money valuation given by those VC investors usually includes the increased/created pool, which means that such VC investor will not be diluted by that creation/increase in the pool. However, in future rounds, if the new investor requires another increase of the pool, every shareholder – including the VC investor – shall be diluted.

6. Exits

6.1 Investor Exit Rights

Shareholders' rights in relation to a sale or any other type of liquidity event are governed by the shareholders' agreement.

The shareholders' agreement includes drag-along rights, tag-along rights and a mandate to sell. The lack of liquidity events led to the inclusion of new exit mechanisms (to be used as a last resort, since they mean less return than a liquidity event) like the possibility to sell the investor's stake without any tag-along rights and priority in secondary sales.

Drag-Along Rights

A drag-along right is the right to force other shareholders to sell their shares in the event of an offer for a certain percentage of the share capital of the company. It is very common to anticipate that a certain offer to acquire the share capital of the company needs to meet certain objective requirements for the VC investors to be dragged to sell their shares. Multiples on the investment,

cash deals, exclusion of the VC investors from the operational representations and warranties are the most common requirements for the VC investors to be dragged.

Tag-Along Rights

Tag-along rights give minority shareholders the option to join a sale initiated by the majority shareholders and are *"must have"* in the shareholders' agreement. However, transfers of shares made by VC investors are usually excluded from the applicability of the tag-along rights.

Mandate to Sell

As funds, the VC investors have a limited duration and usually foresee a divestment/exit strategy, which will be triggered if the company's shareholders do not obtain access to liquidity within a specific deadline, directly related to the fund's divestment period. VC investors will be granted the right to choose an investment bank/consulting firm to sell 100% of the company's share capital.

VC investors usually do not see their shares subject to any transfer restrictions, but the transfer of their shares – other than permitted transfers to affiliates of such fund – will be subject to the right of first refusal from the other shareholders and, where applicable, the drag- and tag-along rights.

6.2 IPO Exits

When Portuguese start-ups are preparing themselves for an IPO, there is usually a jurisdiction flip to a more favourable jurisdiction (in terms of regulation, type of players and financial conditions perspectives).

6.3 Pre-IPO Liquidity

In Portugal, it is not possible to talk about pre-IPO liquidity because Portuguese capital markets are not active in terms of IPOs. Investors, employees and founders shall expect to obtain liquidity through a trade sale. As a result, it is not common for tender offers to occur in the Portuguese capital markets.

7. Regulation

7.1 Securities Offerings

In a securities offering, the immediately applicable regimes – irrespective of the sector of activity of the company – are:

- the Securities Code (*Código dos Valores Mobiliários*);
- the Portuguese Companies Code (*Código das Sociedades Comerciais*);
- Law No 83/2017 of 18 August, which establishes the measures to combat money laundering and terrorist financing; and
- the Portuguese Competition Act (Law No 19/2012 of 8 May).

7.2 Restrictions

Portuguese legal and regulatory frameworks encourage the investment of a foreign VC investor in a Portuguese start-up since there are no restrictions on the entry of foreign capital in Portugal. Since the Portuguese framework is in line with EU regulations, a non-discriminatory environment is followed, so the foreign VC investor will face the exact same challenges/restrictions that a Portuguese VC investor would when investing in regulated sectors (such as telecommunications, energy and insurance).

However, a couple of restrictions may apply to VC transactions (including on foreign investment) in Portugal, as set out below.

- To the extent that the transaction either constitutes (or is deemed to constitute) a concentration falling within the scope of the EU Merger Regulation (Council Regulation (EC) No 139/2004 of 20 January 2004) or of the Portuguese Competition Act (Law No 19/2012 of 8 May), it shall be subject to examination or clearance by the European Commission or the Portuguese Competition Authority.
- For the acquisition of listed companies, the CMVM shall have a say in the matter.
- The Portuguese government has control over the foreign investment – the review being triggered only if the potential acquirer is ultimately owned by an entity outside of the European Economic Area and also if the target assets are deemed *"strategic assets"* for the country – and over concessions for the operation of certain public goods.
- If the company is already subject to any sectoral regulations due to its sector of activity, such regulators shall also review and sometimes approve the transaction.

In addition, due to the EU sanctions on some Russian individuals and Russian entities, it has been extremely difficult for Russian individuals and entities to operate in Portugal.

Trends and Developments

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CCA Law Firm is focused on the future and on helping organisations to achieve the best, boldest and most effective solutions. Innovation is part of its fabric. The firm's culture helps it to break down barriers and stereotypes and create a great work atmosphere that attracts the best talent. CCA is brave enough to find new ways of adding value and know-how to its clients and partners. The firm supports innovation and works with people and companies driven by great ideas, regardless of their size or industry. Its clients range from multinational companies and SMEs to start-ups supported by venture capital or even family businesses or private clients. The firm has offices in Lisbon and Oporto and a network of partners in Europe, Latin America and North America. CCA is a team of business-oriented professionals with a common goal: to change the way legal work is done.

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Introduction

The Portuguese venture capital ecosystem remains robust. The entrepreneurial community continues to expand, attracting an increasing number of international VC funds seeking co-investment opportunities, while new domestic investment funds are entering the market and challenging established players.

At the same time, the Portuguese government is actively rolling out a variety of programmes aimed at fostering innovation and supporting investment across all stages of a company's development. The National Agency for Innovation (ANI) has also issued significant guidelines to facilitate the entry of foreign companies into Portugal, allowing them to benefit from dedicated research and development funding.

Moreover, a new tax incentive programme for scientific and innovation-related activities has been introduced. It provides for a flat 20% personal income tax rate on Portuguese-source income and an exemption on foreign-source income, enhancing Portugal's attractiveness as a destination for innovative talent.

Investment Landscape

Investment funds remain generally interested in seed and Series A rounds, although their approach has become more selective. Investors now commonly require consistent performance metrics before committing to funding. There is also a more cautious tone to investment strategies, with initial tranches of funding often made conditional upon the achievement of specific milestones, such as increases in sales, subscriber numbers, or gross merchandise value (GMV).

Largely due to external factors and the uncertainty surrounding 2024, SAFE rounds have surged in popularity and are now viewed as a credible alternative to priced equity rounds.

Unquestionably, there has been strong demand for AI-focused companies, with artificial intelligence emerging as the industry's defining trend of 2024.

Finally, following the introduction of favourable tax legislation concerning stock option plans, 2024 marked the year many start-ups implemented such schemes. These allow for a single taxable event at the point of liquidity, subject to certain criteria, taxed at a rate of 14%.

Portuguese Government-Backed Programmes

B.P.F. – Banco Português do Fomento (Portuguese Investment Bank) underwent a major restructuring and consolidation process to bring together all investment alternatives under a single umbrella institution. This restructure allows B.P.F. to be more nimble and agile in the decision-making process. The main programmes are:

- Co-Investment Deal-by-Deal: EUR200M for co-investment with private investors in early-stage investment;
- Venture Capital: EUR400M to invest in private investment funds in early-stage investment;
- Consolidar Programme: EUR500M to invest in private investment funds focused on SMEs and mid caps;
- Portugal Blue: EUR50M to invest in private investment funds focused on the blue economy;
- Portugal Growth: EUR100M to invest in private investment funds focused on growth capital and acquisitions; and

- Portugal Tech: EUR100M to invest in private investment funds focused on tech transfer, venture and early stage.

See www.bpfomento.pt/pt/catalogo/produtos-de-capital/.

Portuguese Innovation Agency (A.N.I.)

One of the most successful programmes in recent years was the SIFIDE investment funds, where limited partners that invested in these funds would benefit from a tax break of more than 80% on the amount invested. These funds are only allowed to invest in companies certified by A.N.I.

During 2024, several foreign start-ups were drawn to Portugal by the appeal of these funds, leading many to incorporate wholly owned subsidiaries in the country in order to qualify for them. In response to this growing interest, the Portuguese Innovation Agency clarified that:

- Foreign companies are not required to have maintained a presence in Portugal for at least one year and may benefit from R&D investments made by their parent company.
- Conditional approval may be granted to companies that, at the time of application, have not yet consolidated their R&D teams.
- Fast-track approval is available for incubated start-ups.

This regulatory framework marked a significant breakthrough for Portugal, positioning it as an attractive jurisdiction for foreign start-ups seeking to establish centralised R&D hubs in Europe.

See ani.pt/ani-atualiza-regras-idoneidade-i-d/.

IFICI – New Tax Incentive

In an effort to attract highly skilled professionals to Portugal, the government launched IFICI, the successor to the former Non-Habitual Resident (NHR) regime. This programme, primarily aimed at active professionals engaged in scientific and innovative activities, offers a flat personal income tax rate of 20% on Portuguese-sourced income derived from employment or self-employment. It also grants full exemption on foreign-sourced income, with the exception of pension income and income originating from blacklisted jurisdictions. The benefits under IFICI apply for a period of ten years.

This initiative has undoubtedly captured the attention of founders and other C-level professionals, many of whom have chosen Portugal as their primary residence. They are drawn by the combination of favourable tax conditions, a reasonable cost of living, and a safe, healthy environment for expatriates and their families.

Conclusion

Portugal continues to adopt a holistic approach to fostering innovation and technology. Public and private actors are working collaboratively to create optimal conditions for foreign private investors and founders to relocate, explore opportunities, and engage with the country's dynamic venture capital ecosystem – with a uniquely Portuguese twist.

SINGAPORE

Law and Practice

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Gunderson Dettmer Singapore LLP has over 400 lawyers across 12 global offices (Silicon Valley, Ann Arbor, Atlanta, Austin, Boston, Los Angeles, New York, San Diego, San Francisco, Beijing, Singapore and Sao Paolo), and is a pre-eminent international law firm with an exclusive focus on the innovation economy. The firm has maintained that focus for nearly 30 years, and represents companies and funds of all sizes, from industry leaders worth billions to early-stage companies and first-time funds across the USA, Asia-Pacific, Europe, Latin America and the MENA region. In 2016, Gunderson Dettmer opened its Singapore office to support growth in venture activity across India and South-East Asia. The Singapore team advises emerging growth companies throughout their life cycles, acts for venture and growth equity investors, and has a track record for advising on some of the most significant and landmark financing rounds and M&A transactions in the region.

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GUNDERSON DETTMER

1. Trends

1.1 VC Market

Notable VC Financings of the Past 12 Months

Notable 2024 VC deals involving Singapore-headquartered companies included:

- insurtech start-up bolttech's Series C fundraise – USD100 million;
- semiconductor manufacturer Silicon Box's Series B fundraise – USD200 million;
- AI and data collaboration start-up Atlan's Series C fundraise– USD105 million; and
- open-source developer platform start-up Supabase's Series C fundraise – USD80 million.

1.2 Key Trends

Macroeconomic headwinds, including high interest rates and volatile capital markets, persisted as many start-ups approached the end of their cash runways. Financial irregularities resulted in the repricing and collapse of several start-ups, most notably, the high-profile downfall of agritech unicorn eFishery. Geopolitical challenges, such as wars and tariffs, also had significant repercussions for the fundraising landscape in 2024. Notable trends included:

- further risk shifting in venture financing rounds from investors to founders by requiring founders to stand behind warranties (including being expected to provide uncapped indemnities on an expanded set of fundamental matters, including company financials), and investors conducting additional due diligence before committing to invest;*"wait-and-see"* approach by investors hesitant to commit entire allocations without concrete evidence of performance, resulting in an uptick in tranched closings, with investors retaining the option to invest the remaining amount within a 12- to 18-month period at the same or slightly higher valuation;
- continued preference by companies and investors alike to rely on fundraising through convertible notes in lieu of priced equity financings in order to defer discussions around valuation; and
- pay-to-play structures to incentivise and reward investment by existing investors and penalise non-participants.

For further insight into the terms and conditions characteristic of recent venture financings, please see the Singapore Trends and Developments chapter in this guide.

1.3 Key Industries

Financial services and technology (*"fintech"*) start-ups continued to account for a significant portion of all venture funding in Singapore, particularly those seeking to offer payment and lending solutions to the large unbanked but digitally sophisticated populations in suburban and rural areas. Businesses leveraging blockchain and Web 3.0 technologies to solve foreign exchange and currency inefficiencies also saw success in fundraising. E-commerce and consumer-focused start-ups with reliable revenue streams and the capacity to turn a profit (even at the expense of growth) continued to attract investors with a renewed preference for financial stability over scale.

The application of generative AI (as opposed to traditional, symbolic AI) by start-ups is driving a new wave of investor interest in fintech, healthtech, biotech, e-commerce and many other sectors. Start-ups that adopt the power of AI hold a distinct competitive advantage by harnessing the power of data augmentation to innovate more quickly, optimise processes, and deliver superior products and services. These

start-ups can allocate resources more strategically to uncover patterns and correlations, adapt to changing market dynamics and scale their operations through automation, which frees up monetary and human capital for other core business activities.

The power of AI has been deployed across start-ups operating in many distinct verticals:

- In fintech, AI optimises the assessment of credit risk and default in lending and significantly expedites the loan approval process and pricing of premiums in insurance products. AI tools are also being deployed to provide low-cost financial advice through portfolio strategy and diversification solutions in wealth management. This has spawned significant new investment opportunities in fintech beyond the payment and digital banking solutions previously seen.
- In healthcare, AI enhances telehealth platforms by enabling virtual consultations, assessment of symptoms and remote monitoring of patients.
- In biotech, machine learning accelerates the analysis of vast datasets to uncover patterns, predict drug efficacy and identify novel therapeutic targets, leading to faster and more cost-effective drug development.
- In e-commerce and other direct-to-consumer channels, AI-driven chatbots are providing personalised customer interactions, around-the-clock support, product recommendations and virtual shopping assistance.

For further insights into recent trends in Singapore's venture investment and exit transactions, please see the Singapore Trends and Developments chapter in this guide.

2. Venture Capital Funds

2.1 Fund Structure

Organisation and Documentation of VC Funds

Singapore-managed VC funds commonly opt for a Cayman Islands or Singapore limited partnership. Under both constructs, the main governing document is the limited partnership agreement, with the fund being controlled and managed by the fund's general partner (GP).

Singapore adopted the variable capital company (VCC) legislation in 2020, and a number of Singapore-managed VC funds have successfully utilised this structure. The VCC is a corporate entity that can be used both for traditional and alternative investment funds (including mutual funds, hedge funds, private equity funds and VC funds). VCCs allow for the segregation of assets and liabilities between multiple sub-funds or special purpose vehicles, enabling multiple investment strategies or portfolios to be housed within a single umbrella entity while maintaining limited liability. Under the VCC construct, the main governing document is the shareholders' agreement and constitution.

A mixed structure is also seen where the main pooled investment fund is formed in the Cayman Islands and the Cayman fund establishes a wholly owned VCC in Singapore as a holding company. The Cayman fund then deploys most of its portfolio investments through the VCC, allowing it to benefit from tax treaty advantages associated with the VCC structure.

2.2 Fund Economics

Economics for Fund Principals

Fund principals participate in the economics of the VC fund through two key methods:

- carried interest – typically 20% of fund profits, though this may scale up to 25% or 30% after the overall return to investors has achieved certain milestones (for example, 25% after a 2x return and 30% after a 3x return); and
- management fees – typically 2% to 2.5% of the total capital commitment during the investment period, and thereafter a step down to 1.5% to 2% of the undisposed investments.

Key Terms Relating to Fund Economics

Distribution model

Fund managers with strong bargaining power may negotiate for a deal-by-deal distribution model, where carried interest is calculated with respect to an investment at the time liquidity is realised. This allows fund managers to realise returns earlier. An alternative approach is the return-of-capital model, where carried interest is only calculated after all investments in the portfolio have been liquidated, deferring distributions until the overall fund performance can be ascertained.

Transfer rights

To obtain early liquidity, limited partners (LPs) may negotiate for the right to transfer their partnership interests to third parties prior to the conclusion of the fund cycle.

Investment restrictions

Because of the risks involved in start-up investments, investors may negotiate guardrails around the maximum total fund commitments allocated into a single portfolio company. This is true especially for early-stage-focused funds.

Formation of new funds

To align interests between GPs and LPs, LPs may implement restrictions on the GPs' ability to form any other investment fund with similar objectives and operations until a certain proportion of their fund's capital commitments have been deployed, or for a fixed period after the closing date of their fund.

Advisory committee

Singapore-based VC funds typically have an investors' advisory committee, comprised of three to five members representing the largest investors. Matters involving conflicts of interest are typically subject to advisory committee approval.

2.3 Fund Regulation

Regulations With Respect to Formation of VC Funds

A VC fund formed in the Cayman Islands is generally required to register as *"private fund"*. The Cayman fund may be managed by a fund manager registered in the Cayman Islands or another jurisdiction recognised in the Cayman Islands (Singapore fund managers are recognised). The formation of a VC fund vehicle in Singapore is generally not a regulated activity in Singapore.

Singapore Fund Manager Regulations

Singapore fund management companies with more than SGD250 million of assets under management are required to obtain a licence from the Monetary Authority of Singapore (MAS). Most Singapore-based VC fund managers obtain a venture capital fund manager (VCFM) licence from the MAS, which takes less time to obtain than a full licensed fund management company (LFMC) licence.

A fund managed by a VCFM must invest at least 80% of committed capital in securities that are directly issued by an unlisted business venture which has been incorporated for no more than ten years at the time of the initial investment. In

other words, a fund managed by a VCFM may only invest up to 20% of committed capital in other unlisted business ventures (including secondary investments and any investments in digital assets). Therefore, a secondary fund manager or a Web 3.0 fund manager would have to obtain a full LFMC licence in Singapore.

Securities Laws

A VC fund raising capital from LPs will need to ensure that it is compliant with relevant securities laws of the jurisdictions of such LPs. For example, a VC fund raising capital from US investors is required to comply with US securities laws, typically by qualifying for one or more exemptions from the relevant securities acts.

2.4 Particularities

Notable Trends in VC Funds

In Singapore, Web 3.0 funds are becoming increasingly popular, while impact funds (which are often highly publicised but poorly capitalised) have become less prevalent. Fund-of-funds remain actively involved in investing in VC funds in the region. Singapore government-backed funds such as GIC, Temasek and Pavilion Capital are active LPs in the market. In addition to directly investing in promising start-ups, such funds may also support regional and overseas VC funds as an LP or anchor investor.

Favourable Tax Incentives for Supporting Local Start-Ups

VC funds that focus the deployment of their capital commitments on Singapore-based start-ups may be eligible for Singapore income tax exemptions with relevant approval from certain government agencies, such as Enterprise Singapore (the government agency responsible for promoting enterprise development and supporting the growth of Singapore as a hub for start-ups). A number of other initiatives are undertaken by the Singapore government to promote venture investment (see **4.3 Government Endorsement**).

Extended Holding Periods

To accommodate longer average holding periods for investments, GPs in Singapore may choose to extend the fund term. Any extension of the fund term would typically require the consent of the LPs and/or the advisory committee, and GPs usually forgo management fees during the extended period. Alternatively, if the fund is unable to extend its term or if a secondary purchaser is identified, GPs may raise a continuation fund. A continuation fund provides the capital necessary for a longer holding period without requiring any changes to the original fund term. The GP will also be able to charge management fees and carried interest on the continuation fund.

3. Investments in Venture Capital Portfolio Companies

3.1 Due Diligence

Legal Due Diligence in VC Deals

The scope of legal due diligence conducted by VCs depends on the stage of investment, and whether the investor is a new or existing investor. Investors performing *"high level"* or *"light touch"* due diligence should, at minimum, review the ownership structure and capitalisation and understand the key terms of material contracts and past or pending acquisitions by the company. Intellectual property and regulatory issues may also be important, depending on the nature of the business.

Ownership

Many start-ups with substantial operations in South-East Asia and India, among other regions, choose Singapore as their place of incorporation, but record revenues, incur expenses, hire

talent, enter into contracts and hold tangible and intangible assets through foreign subsidiaries. Because investors purchase and hold their equity in the Singapore entity, it is important to ensure that any value derived from downstream subsidiaries flows back to the parent with minimal leakage. Most subsidiaries are 100% wholly owned, though in certain countries (such as Indonesia and Vietnam) subsidiaries frequently enter into a nominee ownership structure with the parent.

Capitalisation

Issued and outstanding shares of Singapore companies are recorded by the Accounting and Corporate Regulatory Authority of Singapore (ACRA), including the Electronic Register of Members (EROM). Under the Companies Act 1967 of Singapore (the *"Companies Act"*), certain entries in the EROM are prima facie evidence of their existence, so companies should ensure that their corporate secretary provides up-to-date and accurate lodgements of changes to the share capital. The requirement to maintain an EROM has only been in effect since 3 January 2016. As a result, corporate transactions prior to that date may not be completely reflected in a company's EROM, and the correctness of the EROM (and all other records maintained on ACRA) is ultimately dependent on the corporate secretary's efforts, and, as discussed below, may not reflect recent transactions.

Although the accuracy of these registers ultimately depends on the underlying information provided to the corporate secretary, VC investors generally rely on these registers to ascertain the share capital of the company, rather than undertaking an independent *"tie-out"* or chain-of-title review. However, in acquisitions and exit transactions, it is not unusual for a buyer to perform a comprehensive review of the relevant corporate approvals, share transfer or application forms, and subscription/transfer agreements. Ongoing system updates to the ACRA portal in December 2024 have resulted in delayed updates to the EROM for transactions affecting share capital (including issuances and transfers). Until ACRA returns to full functionality, investors should consider whether a comprehensive tie-out is appropriate, and should also ensure that contractually, they are treated as shareholders upon funding even if the EROM is only updated retroactively at a later date.

Investors should note that the number of shares reserved for issuance under a company's employee share option plan (ESOP) is not typically recorded with ACRA, and must be verified by a review of the relevant resolutions and underlying documents. Understanding the precise number of shares reserved under the ESOP is an important part of the diligence exercise, as it directly impacts an investor's fully diluted ownership stake.

Material contracts

Depending on the nature and complexity of material contracts, investors may either conduct *"red-flags"* or in-depth review. This is true especially for the start-ups in the enterprise software, manufacturing and supply sectors, where several large customer contracts may account for a substantial portion of overall revenue. Key considerations include:

- understanding monetary obligations, whether in the form of fees, contingencies, royalties or other payments;
- termination provisions (including whether either party may terminate for convenience, and if so, whether a substitute counterparty is available on commercially similar terms);

- exclusivity terms regarding inbound and outbound licensing of technology, anti-competition restrictions and other restrictions on the company's business;
- anti-assignment terms, which may delay a future exit (particularly if such transaction is structured as an asset sale);
- burdensome warranties or covenants that are impractical for an early-stage start-up to satisfy; and
- high liability caps or uncapped liability that could expose the company to extensive damages in a breach, especially in businesses that may be more vulnerable to product liability claims, or companies that aggregate or store sensitive customer data.

Acquisitions

If the company has engaged in any past acquisitions or business combinations, or is in the process of negotiating such transactions, it is important for an investor to understand what contingent obligations the company may continue to owe to the counterpart(ies), including:

- any earn-out arrangements and other retention or similar obligations to sellers' employees and founders;
- escrow or holdback arrangements that may not be immediately recorded, but which the company will need to account for in the future, whether in cash or equity; and
- breaches or potentially indemnifiable losses identified at closing, if a full audit cycle has not yet been completed on the target.

Intellectual property

Intellectual property (IP) diligence includes ensuring that:

- all IP necessary to operate the business is properly owned and enforceable against infringing third parties; and
- the company is not infringing third-party IP.

Ownership diligence involves ensuring that:

- all service providers who have contributed to the development of IP have assigned all inventions created in relation to their engagement without further action required to effect the assignment;
- no other person (whether a joint venture partner, research institution, governmental body or otherwise) owns or may claim joint ownership of the company's IP;
- the company has proper policies in place for the protection of its codebase and its trade secrets;
- the company has validly registered, and maintained its registrations for, all registrable IP, including copyrights, marks and patents;
- the company has proper licences on sustainable terms for requisite third-party IP, and has provided licences to use its IP under enforceable and sustainable terms; and
- the company is not using any open-source software subject to copyleft licences that would require the company to distribute/reveal its source code.

Non-infringement diligence involves confirming:

- general compliance with third-party licences and no pending or threatened claims;
- that the company has reasonable policies in place governing the use of open-source soft-

ware, or is, at a minimum, keeping track of its use of open-source software; and
- in a minority of cases (primarily due to cost), that the company has conducted freedom-to-operate analyses in certain markets.

Regulatory matters

Companies operating in regulated sectors – such as direct-to-consumer goods, financial services (particularly payments and lending), insurance underwriting, education, healthcare and life sciences, and the development of critical technologies with national security implications – should ensure they possess the requisite licences to operate. Compliance with local labour, tax and securities laws are also common focal points of due diligence.

Non-legal Due Diligence

Non-legal business and financial due diligence has historically been performed in-house but is increasingly being outsourced to professional vendors. This is particularly true in later-stage companies, where VCs frequently engage audit and forensics firms to review company accounts, examine ownership structures, conduct litigation searches and inspect the personal backgrounds of key personnel. Such qualitative diligence processes have become standard practice in recent years, and regional VCs are seeking increasingly higher reimbursements for their vendor expenses as a result of such exercises.

3.2 Process

Timeline for Growth-Stage Financing

The timeline for a financing round in the growth stages ranges from 12-16 weeks from the signing of a term sheet, and investors typically negotiate for an exclusivity period (during which the company must negotiate in good faith and must not actively solicit competitive term sheets) of 60 to 90 days. In the past few years, as growth funding became less accessible, the commercial due diligence timeline leading up to a term sheet has expanded, with investors sometimes engaging in conversations with start-ups for months before seeking formal investment committee approval. For growth-stage companies with a large investor base, the tension between existing investors reluctant to concede favourable terms to new investors and new investors unwilling to fund without additional protections can result in a protracted negotiation and approval process.

Involvement of Counsel

Separate counsels are typically engaged by the lead investor and the company, and existing investors may also engage independent counsel to review revised agreements once these are substantially agreed with the lead investor. Unsurprisingly, timelines and costs almost always directly correlate to the number of parties involved in negotiations, and it is not unusual for existing investors participating in a new round to seek expense reimbursement for their advisers.

Consent Thresholds

Shareholder agreements are typically structured to allow for new financings to take place and for amendments to be made without having to obtain unanimous shareholder consent. However, the consent of a specified majority of a class of shares is typically required. In addition, the consent of at least 75% of the outstanding shares (on an as-converted-to-ordinary-shares basis, in the case of preference shares) is required under the Companies Act to amend the constitution of the company, which is required to establish the rights of any new class of preference shares.

The consent of a majority of the outstanding shares (on an as-converted basis) is also required under the Companies Act to issue new shares. Unless certain requirements are met,

the authority to issue new shares expires at the conclusion of the next annual general meeting (AGM) or on expiry of the period within which the next AGM is required to be held by law.

3.3 Investment Structure

Standard Economic Rights in Early-Stage Financings

A new class of preference shares is typically established in connection with a venture financing. These preference shares feature downside protections, including:

- anti-dilution rights (eg, the right of an investor to adjust their fully diluted stake in the company and to protect their ownership percentage in the event of a future *"down round"*) and
- liquidation preferences (the priority in which investors are paid in the event of a company's liquidation, sale or dissolution).

Standard terms of preference shares include *"broad-based weighted average"* anti-dilution rights protections which account for the size and severity of a future down round, and *"1x, pari passu, non-participating liquidation preference"* which provides newly issued shares priority in distribution up to the dollar amount of their principal in the company, on equal seniority with other preference shares, and without *"double dipping"* or participating with the remaining proceeds distributable to ordinary shares.

Contractual Rights

Shareholders' agreements generally include extensive negotiated contractual rights. These include:

- board and observer rights, which detail entitlements to nominate directors or non-voting observers;
- information rights, which require the company to periodically provide certain financial reporting and operating metrics to investors, as well as annual budgets and business plans;
- pre-emption (or pro rata) rights, which provide some or all investors with the right to maintain their ownership percentage by investing in future rounds;
- rights of first refusal (or first offer) and tag-along rights over the shares held by other shareholders (typically founders), which allow investors the first right to purchase shares being sold by founders or, alternatively, to participate in a sale transaction by founders to a third-party buyer;
- drag-along rights, which enable a subset of shareholders to force a minority of shareholders to participate in an exit; and
- board and shareholder reserved matters, which set out actions that the company may not take without the approval of a certain group of investor directors and/or preference shareholders.

It is not uncommon to confine certain rights to *"major investors"* holding a specified percentage of the share capital, and to require *"burn-off"* threshold with respect to board and observer rights, where an investor that has been diluted below a certain ownership percentage over time will lose such rights.

Founder Transfer Restrictions, and Good and Bad Leaver Provisions

In addition to subjecting founder shares to the aforementioned restrictions, investors typically expect founders' shares to be re-vested or subject to lock-ups. Founders may negotiate for *"liquidity basket"*, whereby a portion of their shares may be freely transferable without being subject to such transfer restrictions.

Finally, *"good"* and *"bad"* leaver scenarios and associated claw-back rights in founder equity are staple terms in shareholders' agreements. A bad leaver is typically defined as a founder who has been terminated for *"cause"* or has resigned without *"good reason"*, and the definitions of *"cause"* and *"good reason"* are heavily negotiated.

In a bad leaver scenario, the company and, occasionally, other investors, may have the right to purchase some or all of the vested equity held by a founder at nominal value or a discount to the *"fair value"* of such shares. Fair value of ordinary shares may be assessed by an independent third-party appraiser or be pegged to a percentage of the latest preference share price. In a good leaver scenario, vested equity may not be subject to a right of purchase, or may be subject to such a right only at fair value. In both good and bad leaver cases, unvested equity is purchasable by the company at nominal value.

3.4 Documentation

Singapore Forms for Pre-seed and Later-Stage Rounds

Singapore companies raising pre-seed investments typically use convertible notes or simple agreements for future equity (SAFEs) on widely adopted industry forms. When raising the first (and subsequent) priced equity round(s), the key definitive documents are:

- a subscription agreement, governing the subscription terms of the preference shares being issued;
- a shareholders' agreement, governing the rights and obligations between the incoming and existing shareholders and the company; and
- an amended and restated constitution, providing for other corporate governance matters and replicating certain key provisions of the shareholders' agreement.

If there is any inconsistency between the shareholders' agreement and the constitution, the shareholders' agreement generally prevails.

Relevance of US NVCA Model Forms

The documents published by the US National Venture Capital Association (NVCA) are rarely relied upon by regional investors. However, when drafting and negotiating Singapore law-governed shareholders' agreements, the standards set by the NVCA remain a useful point of reference due to the developed and sophisticated venture market in the USA and the prevalence of US VCs investing in Singapore-headquartered companies.

3.5 Investor Safeguards

Please refer to Structured Rounds and Downside Protections in the Singapore Trends and Developments chapter of this guide for a discussion of the structures and terms used by investors in recent down cycles.

Common Terms in a Down Round

The starting point for structuring any down round is to ascertain whether the requisite consents required by the shareholders' agreement and constitution (and any other documents) can be obtained. For example, new investors in a down round may expect anti-dilution protections to be waived by existing investors, so as not to severely penalise founders who often bear the burden of the anti-dilution adjustment.

A down round investor will usually expect seniority in liquidation preference, dividends and redemption terms. Investors may also negotiate for a multiple on their liquidation preferences, and for participation rights, as well as ratchet

anti-dilution protections to *"reset"* their entry valuation in the event of future down rounds, although this remains the minority approach. Significant governance oversight may be enforced through extensive reserved-matter rights, along with transfer restrictions on the shares of founders and other investors to prevent a premature exit. Lastly, investors may also negotiate for favourable terms in a future upside scenario, including super pro rata rights that exceed their post-closing ownership percentage.

Minority Protection Under the Companies Act

The Companies Act provides a number of statutory protections for minority shareholders. Section 74 provides minority shareholders with the ability to apply to cancel a variation or abrogation of their class rights in certain circumstances, and Section 216 provides the ability to apply for relief under the oppression remedy.

3.6 Corporate Governance

Board- and Shareholder-Reserved Matters

Investors exercise influence over governance and operations by stipulating consent requirements for certain actions taken at the board and shareholder level. Board-level oversight is typically required for operational matters, including:

- the incurrence of debt;
- entry into agreements outside the ordinary course of business;
- significant deviations from the business plan and budget;
- executive compensation and approval of equity awards for key personnel; and
- hiring or firing of key personnel.

Shareholder-level oversight is typically required for matters that directly impact the value of an investor's ownership stake and the rights attached to their shares, including:

- amendments to the shareholders' agreement and to the constitution;
- the amount of equity reserved under the ESOP;
- liquidity events; and
- dilutive issuance of new securities.

Board-level matters typically require the consent of a specified number of investor-nominated directors, whereas shareholder-level matters typically require the consent of investors holding a specified percentage of preference shares.

Ultimately, the enforcement of reserved matters is a matter of contract, and it may not be feasible to unwind actions taken without proper consent, especially when such unauthorised actions are effected by subsidiaries in foreign jurisdictions. Investors should consider implementing practical measures to mitigate risk, including adopting robust banking policies requiring multiple signatories for large account withdrawals, to guard against the risk of misappropriation and embezzlement.

3.7 Contractual Protection

Founder Liability

In early-stage financing rounds, founders may be liable on a joint and several basis with the company for breaches of warranties and undertakings provided in the subscription agreement. They may also be required to provide a personal indemnity for such breaches. While this position may be justifiable for an early-stage company with limited assets, founder liability is often omitted in subsequent rounds as the company matures and its recoverable assets increase.

Indemnities

General, and sometimes specific, indemnities are typically included in subscription agreements. Indemnities should be limited, including

through a survival period, de minimis thresholds and baskets. Recovery from founders is usually limited to the value of their shares in the company. Early investors should be mindful that draconian indemnity terms with lengthy survival periods will be viewed unfavourably by future investors, who will not want their invested capital to backstop the indemnity rights of their predecessors.

Disclosure Schedules

Disclosure schedules play an important role in qualifying the warranties made in the subscription agreement. General data room disclosure, whereby all documents uploaded to the data room on a given date are deemed disclosed, is typically paired with specific disclosures. In such cases, parties usually negotiate for *"fairly disclosed"* concept.

Post-closing Covenants

Deficiencies identified during the diligence and disclosure process may be rectified pre-closing or deferred to post-closing covenants. Requiring matters to be resolved on a post-closing basis may be preferable if the matter is not material and if parties are aligned on closing expediently.

Enforcement for Breach

For reputational and cost reasons, it is rare for a VC to bring legal action against a company on the basis of a breach of warranties or covenants in the absence of fraud or gross negligence. As a result, investors should ensure that they thoroughly assess the reputation and capabilities of founding teams as well as the internal controls and governance of the company prior to closing.

4. Government Inducements

4.1 Subsidy Programmes

Government Programmes

The Singapore government provides a number of grants for supporting local founders and start-ups. These include:

- the Start-up SG Founder Grant, which covers a wide scope of business ideas;
- the Start-up SG Tech Grant, which focuses on new or early-stage start-ups; and
- the Enterprise Development Grant, which focuses on growth and technology adoption.

Such grants are typically only available to Singapore-incorporated entities that satisfy minimum Singapore citizen/permanent resident ownership requirements.

Seeds Capital, the investment arm of Enterprise Singapore, incentivises equity financings in Singapore-based start-ups by providing co-investments alongside a list of approved VC funds. Deep tech companies are eligible for higher co-investment.

4.2 Tax Treatment

Tax Treatment of Start-up Equity

There is no capital gains tax regime in Singapore, but, at the point of sale or transfer, stamp duty is payable to the Inland Revenue Authority of Singapore (IRAS) at the higher of 0.2% of:

- the consideration received for the sale of such shares; or
- the net asset value (NAV) of the relevant shares.

The IRAS prescribes guidelines on the calculations of NAV of shares for the purposes of stamp duty. Generally, dividends distributed by Singa-

pore private limited companies to their investors are not taxable.

4.3 Government Endorsement

See **4.1 Subsidy Programmes**.

Government Initiatives

Institutions such as SGInnovate (a private organisation wholly owned by the government) and EDBI (the corporate VC arm of the Singapore Economic Development Board (EDB)) have funds available for supporting Singapore-based start-ups and start-ups with a Singapore nexus. SGInnovate focuses on developing human capital in the Singapore deep tech ecosystem, by conducting talent programmes and facilitating the sourcing and hiring of deep tech talent through *"Deep Tech Central"* platform. In addition, the Ministry of Trade and Industry established the Action Community for Entrepreneurship, which is committed to helping local start-ups fine-tune their business proposals and participate in a suite of incubator and mentorship programmes.

Relocating to Singapore

In 2023, EDB launched the Global Investor Programme (GIP), which accords Singapore permanent resident status to eligible global investors seeking to relocate and deploy their investments from Singapore. Investors may qualify by demonstrating an investment of at least SGD10 million in a new business entity or in the expansion of an existing business operating in Singapore, by investing SGD25 million in *"GIP-select"* fund that invests in Singapore-based companies, or by establishing a Singapore-based single family office with assets under management of at least SGD200 million (a minimum of SGD50 million must be transferred into Singapore and deployed in EDB-specified investments).

Programmes for facilitating expansion

Enterprise Singapore is spearheading the Global Innovation Alliance (GIA) comprised of Singapore and overseas partners in the technology and innovation space. As part of the GIA, start-ups may access:

- acceleration programmes for facilitating entry into overseas markets; and
- co-innovation programmes for collaborating on research and development with foreign partners.

Exit on Singapore Exchange (SGX)

Later-stage start-ups seeking exits may find support from SGX's Strategic Partnership Model, whereby SGX, Singapore's national stock exchange, charts a bespoke framework for companies moving towards an IPO on SGX. This includes leveraging SGX's network of investors to:

- supplement and strengthen a company's existing shareholder base;
- provide support during the IPO process; and
- drive growth post-IPO.

The Singapore government further provides support for later-stage start-ups seeking to list on the SGX through growth equity investments via Anchor Fund @ 65 (a co-investment fund with Temasek) and EDBI's Growth IPO Fund. These funds also assist their portfolio companies with the listing requirements for an IPO on the SGX.

5. Employment Incentives

5.1 General

Incentivising Founders and Key Employees

Founder equity is issued at incorporation, and investors generally expect such equity to be

earned out over a number of years through time-based vesting. Other employees are granted options when they commence their services to the company, also subject to time-based vesting. After the company has raised funding, options are typically granted in lieu of shares because under the tax laws of most countries, the appreciation in value of options becomes taxable only at exercise, whereas the increase in value of shares is taxable as the shares vest.

At the time of a financing, re-vesting of all or a portion of vested equity may be required. The amount and duration of a re-vest are terms typically negotiated in a term sheet. Founders and key employees may also negotiate for:

- *"single trigger"* acceleration, where all or a portion of unvested equity accelerates and becomes vested upon a liquidity event; or
- *"double trigger"* acceleration, where unvested equity accelerates if a founder/key employee is terminated immediately before or within a period following a liquidity event.

In some cases, founders/key employees may negotiate for partial single or double trigger on a portion of unvested equity. Acceleration features are meant to incentivise employees to work towards a successful exit event, with the assurance that they will not be denied an opportunity to earn out or realise unvested value.

Founders and key employees diluted over time may be rewarded with refresh equity. Such equity may be subject to milestone and KPI vesting terms or to non-traditional time-based vesting schedules.

5.2 Securities

Share Options

Options are the most common form of equity awards for start-up employees, and form an important part of an employee's compensation package. Most grants are subject to a vesting schedule with *"cliff"*, whereby a portion vests on the one-year anniversary of the employee's employment with the company, and the remaining vests monthly or quarterly in equal instalments thereafter.

Vested options may be exercised for shares. Companies typically require employees who have left the company to exercise options within a 60- to 90-day timeframe, failing which, options lapse and are deemed forfeited. The intention is to ensure that departed employees who are no longer contributing to the business do not benefit from the continued upside.

Strike Price

To exercise an option, the holder typically needs to pay an exercise price or strike price set at the time of the option grant. Employees subject to US tax may only receive options with a strike price at or above fair value, but Singapore and most other countries do not have specific requirements relating to the setting of the strike price. A nil or nominal strike price is not uncommon in Singapore and is highly beneficial for option holders. However, having a meaningful strike price (even if at a discount to fair value) rewards earlier employees and may better align the incentives of later employees.

Acceleration

In contrast to founders and key management, acceleration of vesting for rank-and-file employees is uncommon. Investors view acceleration terms as being dilutive to their interests at the time of exit, and a potential acquirer will also

factor such terms into their ability to retain such employees after an acquisition. If employees are significantly or fully accelerated on their unvested equity, an acquirer may need to offer additional equity to such persons as part of their retention package, resulting in dilution to their stakeholders.

5.3 Taxation of Instruments

ESOP Tax Considerations

Singapore does not have a capital gains tax regime. However, individuals who are granted options will be taxed on any gains or profits arising from their participation in an incentive pool as part of their income tax, and Singapore applies a progressive tax rate for individuals.

Tax is assessed at the point of exercise of options, and is calculated on the spread between the fair value at exercise and the strike price paid. If shares are subject to a selling restriction/moratorium period, the gains are calculated as of the date such restrictions are lifted. Subject to certain criteria, an option holder may apply to have their payment of tax on exercised options deferred for up to five years, but interest must be paid on such a deferral.

Foreign employees who terminate their employment in Singapore are subject to the *"deemed exercise"* rule, whereby taxable gains from unexercised options (as well as exercised but restricted options) become immediately due. Such gains are deemed as income derived on the later of one month before the cessation of employment or the date of grant. Under the alternative *"tracking option"*, employers that satisfy certain criteria with approval from the IRAS may bear the responsibility of:

- keeping track of unexercised options;
- computing and reporting gains from specified income-realisation events; and
- collecting and paying taxes on such gains.

5.4 Implementation

ESOP Considerations in a Financing Round

Start-ups raising their first priced equity round usually adopt an ESOP prior to or concurrent with the closing. In later rounds, investors will typically require an ESOP top-up in connection with the new raise. Existing shareholders and new investors will expect clarity regarding who bears the burden of the top-up dilution. An ESOP increase associated with a financing will be dilutive to either:

- the existing shareholders only (in which case it is counted entirely against the pre-money fully diluted capitalisation); or
- both the existing shareholders and the new shares issued in connection with the new round (in which case some or all of the increased amount is counted against the post-money fully diluted capitalisation).

Investors participating in a round should be clear about what their invested capital means in terms of their post-closing fully diluted ownership percentage. From the investors' perspective, counting the ESOP increase against the post-money is tantamount to a valuation adjustment, as they will be immediately diluted by such increase after closing; thus, for simplicity, the ESOP increase is almost always counted against the pre-money capitalisation and is non-dilutive to newly issued shares.

Option Pool Increases

Determining the appropriate quantum of an ESOP increase is ultimately a commercial decision, but a common benchmark is to increase the ESOP by an amount needed to assure new

round investors that the company will have sufficient hiring runway for a reasonable period. In early-stage companies this may simply be until the next expected fundraise (eg, the company's expected cash runway) while in later-stage companies the amount is usually expected to support a 9- to 12-month hiring runway, after which such investors will be expected to share in the dilution of any additional ESOP increases.

In earlier rounds, start-ups may be expected to allocate a greater percentage towards the available and unissued ESOP, as such start-ups generally cannot offer lucrative cash compensation packages to employees and rely heavily on equity compensation to subsidise, resulting in accelerated depletion of the available ESOP. If a start-up has promised, but has not yet formally issued, a certain number of shares out of its ESOP, it will typically be expected to account for such promised equity as issued and outstanding for the purposes of determining the unallocated and available ESOP.

6. Exits

6.1 Investor Exit Rights

Exit Rights

Common exit-related provisions include:

- registration rights in connection with a public offering or follow-on offering;*"change of control"* tag-along rights;
- drag-along rights;
- redemption rights; and
- undertakings to use *"reasonable"* or *"best"* efforts to enable an investor exit within an agreed period of time.

Registration rights provide certain investors with the right to force a company to undertake a registration process with the relevant securities regulators, to register their shares for sale to the public.

Tag-along rights allow investors to co-sell a proportion of their shares alongside sales by founders and, potentially, other shareholders. Investors typically negotiate for *"change of control"* tag-along, whereby they are entitled to sell their entire stake in the company should a sale by founders or other shareholders result in a change of control of the company's voting power. The intention is to ensure that investors who invested in a start-up governed by collective control among minority shareholders should not be *"stranded"* if the start-up becomes majority owned by a single shareholder.

Drag-along rights empower the board and shareholders to compel the sale of all or a significant majority of the company's share capital to a third party. Investors may occasionally seek the ability to unilaterally initiate a drag sale after a set number of years. However, enforcing this provision can be challenging in practice, as it is unlikely a company will execute a successful sale process without the support of management and/or other major investors.

Redemption or buyback rights provide an investor with the right to put their shares to the company after a number of years. The enforceability of such provisions is dependent on the company's solvency and other statutory limitations. Such rights are uncommon, and early-stage investors seeking such rights should be mindful that later investors will almost always negotiate for similar rights on par with, or senior to, their rights of redemption, which may have a counterproductive effect.

Investors commonly require a company to use reasonable or best efforts to facilitate an exit (whether through a trade sale or secondary sale) within a number of years. It remains to be seen whether and how such rights will be enforced in practice. The general consensus is that such efforts are limited to entertaining exit opportunities in good faith and providing support in the due diligence of the company's business by an interested third-party buyer, but stop short of devoting substantial company resources or hiring a financial adviser to run a sale process. However, investors may sometimes specifically require that the company hire a financial adviser at the company's expense to run a formal sale process upon the expiry of the exit term.

Exit Triggers

Events triggering exits typically include:

- any sale of shares that results in a change of control of the company;
- asset sales where the company disposes of all or a substantial amount of its undertakings and assets; and
- public listings.

Investors may require that, if the company exits via a public listing, the listing must satisfy certain criteria (a *"Qualified IPO"*). Common requirements include:

- that the listing be firmly underwritten and launched on a reputable securities exchange with meaningful trading liquidity;
- that the gross cash proceeds from the listing exceed an agreed dollar amount; and
- that the listing be priced at a certain valuation or implied market capitalisation.

6.2 IPO Exits

IPO exits for Singapore start-ups have been sparse, particularly on established global exchanges such as the NASDAQ, NYSE and HKSE. Considerations that drive the timeline for an IPO include:

- the profitability and creditworthiness of the company;
- market conditions;
- retail investors' awareness of the company; and
- the company's growth potential.

6.3 Pre-IPO Liquidity

Restrictions on Secondary Sales

Most companies do not place significant restrictions on the transfer of shares by investors, as such investors generally expect their equity in the company to be freely transferable. However, it is not uncommon for certain companies to disallow transfer of shares by investors to their direct competitors. In such cases, companies and investors may agree to a narrow definition of *"competitor"* which may include a specified list, updated on a periodic basis.

Employee Liquidity

To facilitate employee liquidity, companies occasionally implement employee liquidity programmes. Such programmes may be structured as a company buyback programme funded by a third-party investor in a new financing round. In such cases, the company allocates a portion of the new funding round proceeds to redeem shares from employees who wish to sell.

Alternatively, companies may facilitate the sale of employee shares through a third-party-sponsored tender offer. Under such arrangements, eligible employees are offered the opportunity to sell their shares in the tender offer, subject to

limitations placed by the company on the number of shares tendered by such employees. The company then selects certain buyers to submit a tender offer, and acts as the transfer agent for such shares.

7. Regulation

7.1 Securities Offerings

The Singapore Securities and Futures Act 2001 (SFA) provides that all offers of securities by a Singapore company are subject to prospectus requirements, unless such offer falls within a list of exemptions. Common exemptions include the following.

Institutional and Accredited Investors

Subject to conditions set out in Sections 274 and 275 of the SFA, offers of securities to *"institutional investors"* and *"accredited investors"* (as defined in the SFA) will be exempt from prospectus requirements. As an anti-avoidance mechanism to prevent the circumvention of prospectus requirements, shares allotted and issued under such exemptions are not permitted to be sold (save to other persons specified in Sections 274 and 275 of the SFA) within the first six months of such shares being acquired.

Private Placements

Subject to conditions set out in Section 272B of the SFA, offers of securities to no more than 50 offerees within a 12-month period will be exempt from prospectus requirements. The 50-person limit is based on investors that are offered securities, and not on the number who ultimately invest.

Small Offers

Subject to conditions set out in Section 272A of the SFA, *"personal"* offers of securities of up to SGD5 million within a 12-month period will be exempt from prospectus requirements. *"Personal"* offers may only be accepted by the offeree in question and can only be made to persons that are likely to be interested in the offer based on past contact or connections.

ESOPs

Section 273(1)(i) and (4) of the SFA provide that offers of securities under employee share schemes to *"qualifying persons"* will be exempt from prospectus requirements. These *"qualifying persons"* are directors, employees (including former employees), consultants, advisers, and, in the case of directors and employees, their immediate family members.

In addition to complying with the SFA, Singapore-based start-ups should be mindful of compliance with the securities laws of the jurisdictions in which their prospective investors reside.

7.2 Restrictions

Foreign Direct Investment Considerations

Singapore is generally regarded as a friendly jurisdiction for foreign direct investment, but, like many countries, foreign investments are subject to strict anti-bribery, anti-money laundering and counter-terrorism financing regulations. Further, in a subset of regulated sectors (such as financial services, media, telecommunications and utilities), foreign investment may require regulatory approval and may, in some cases, be subject to foreign ownership limitations.

Singapore's Significant Investments Review Act came into force on 28 March 2024, whereby investors in designated entities identified as critical to Singapore's national security interests are required to:

- obtain approvals from the Minister for Trade and Industry (MTI) before acquiring *"controller"* stakes in such entities; and
- notify the MTI upon becoming a 5% controller of such entities.

The list of designated entities, which is subject to change from time to time, was released on 31 May 2024 and updated on 21 November 2024. The list is narrowly tailored and comprises only ten corporations as of March 2025. As a result, it is unlikely to have any meaningful impact on most VC investments.

Trends and Developments

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Gunderson Dettmer Singapore LLP has over 400 lawyers across 12 global offices (Silicon Valley, Ann Arbor, Atlanta, Austin, Boston, Los Angeles, New York, San Diego, San Francisco, Beijing, Singapore and Sao Paolo), and is a pre-eminent international law firm with an exclusive focus on the innovation economy. The firm has maintained that focus for nearly 30 years, and represents companies and funds of all sizes, from industry leaders worth billions to early-stage companies and first-time funds across the USA, Asia-Pacific, Europe, Latin America and the MENA region. In 2016, Gunderson Dettmer opened its Singapore office to support growth in venture activity across India and South-East Asia. The Singapore team advises emerging growth companies throughout their life cycles, acts for venture and growth equity investors, and has a track record for advising on some of the most significant and landmark financing rounds and M&A transactions in the region.

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GUNDERSON DETTMER

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Overview

Singapore continues to solidify its status as the most reliable destination for investors seeking exposure to South-East Asia's start-up ecosystem, accounting once again for more than two-thirds of all venture dollars deployed, and a significant majority of venture financing transactions, among start-ups operating in ASEAN. According to Enterprise Singapore, Singapore is home to more than 4,500 start-ups, 400 VC firms and 220 incubators and accelerators, and ranks among the top five cities globally in total venture dollars invested into VC-backed companies, behind only Silicon Valley, New York, London and Beijing.

The past year was by all accounts another challenging year for regional VC fundraising by start-ups and funds alike. Nearly all key metrics – aggregate dollars raised, aggregate deals closed, median valuations, median check sizes, and the number of new funds announced and closed – continued to experience a year-on-year decline that started in 2023. By contrast, more mature markets such as the USA experienced a gradual recovery in VC funding, fuelled by the enthusiasm surrounding AI and AI-focused technologies.

Nevertheless, there were some positive developments in the market over the past year, as investors began to shift their focus from mainly supporting existing portfolio companies to showing a greater willingness to allocate capital toward new opportunities. These investments were generally accompanied by increased scrutiny, stricter governance terms, and carefully crafted downside protections.

Continued Decline in Regional Start-Up Fundraising

The region's recovery from the funding winter continues to face global macroeconomic and geopolitical challenges. Persistent inflation and elevated interest rates in some of the world's largest economies have depressed capital markets activity and led to increased stock market volatility. Wars, elections, political tensions and tariffs have continued to disrupt global supply chains and trade, resulting in further uncertainty for investors and operators alike.

Many large multinational corporations and institutions opted to focus on cash preservation and organic growth of their core businesses rather than pursuing acquisitions and outbound investments. Meanwhile, traditional institutional investors, including pension funds, endowments and sovereign wealth funds, chose to allocate their capital into private credit and public equities instead of venture funds. The lack of exits in South-East Asia also led crossover funds and hedge funds – which had previously provided numerous secondary exit opportunities for early-stage investors like VCs – to reduce their exposure in private companies. Finally, many global investors with an emerging markets mandate chose to redirect their capital to countries like India, where capital markets activity remained robust.

According to DealStreetAsia, approximately USD4.5 billion was invested into South-East Asian start-ups in 2024, representing a 42% decline from 2023. The total number of successful deals in South-East Asia tracked by DealStreetAsia also fell more than 10% from 2023, to just 633. Pitchbook reported slightly higher overall figures, tracking 980 successful deals totalling USD7.6 billion in the region, represent-

ing an over 30% decline in deal value and 16% decline in deal count.

This reflects a trend observed in other emerging markets. The Middle East experienced a year-on-year decline of 29% in 2024, while Africa saw a drop of 44%, according to deal data compiled by Magnitt. In contrast, venture funding in the USA rose by over 20% year-on-year in 2024, and Europe experienced only a modest decline of 5%, as reported by Crunchbase. Latin America was the lone standout among emerging venture markets, with a 27% increase in dollars deployed in 2024, but struggled with currency depreciation amid a rise in the value of the US Dollar.

While the statistics may paint a bleak picture for Singapore and other South-East Asian nations, it is important to note that many regional start-ups opted to obtain fresh funding through convertible instruments instead of traditional priced equity rounds, and such transactions are typically not publicly disclosed nor are they required to be filed in public databases. Nevertheless, it is undeniable that the recovery and uptick in deal-making activity that many in the region anticipated and hoped for did not materialise.

Deal Highlights

Singapore-headquartered start-ups continued to account for the majority of headline-grabbing deals in 2024. Semiconductor manufacturer Silicon Box completed a USD200 million Series B round that began in 2023, while insurtech start-up bolttech secured over USD100 million in a Series C round. AI and data collaboration start-up Atlan raised USD105 million in its Series C funding, open-source developer platform Supabase secured USD80 million in a Series C round, and wealth management platform Endowus raised over USD50 million in a funding round that started in 2023. Philippine fintech start-ups also experienced success in 2024, with Mynt raising over USD300 million to achieve a valuation of USD5 billion, BillEase completing an undisclosed Series C round led by TPG's The Rise Fund, and consumer fintech Salmon Group raising two rounds totalling USD55 million to scale its lending business.

The fintech sector, driven by start-ups specialising in payments, decentralised finance, lending, and wealth management solutions, remained the most active sector in South-East Asia for capital deployment by VCs, followed by e-commerce and software. Start-ups developing software-as-a-service (SaaS) solutions experienced increased success in attracting capital from outside the region, primarily due to their focus on large enterprise customers and pursuit of global go-to-market strategies.

VCs Struggled to Raise New Funds and Close Previously Announced Funds

Regional VC firms continued to encounter significant challenges raising new funds and closing previously announced funds due to an abundance of previously raised but undeployed *"dry powder"* capital and a reduction in funding by limited partners. In 2023, both the value and number of VC funds closed saw a sharp decline compared to 2021 and 2022. Nevertheless, some VCs managed to achieve interim or final closings on funds that they had started raising during those prior years.

Unfortunately, but unsurprisingly, this same momentum did not carry from 2023 into 2024. According to DealStreetAsia, South-East Asia focused VCs closed just 14 new funds for an aggregate of USD2.15 billion in capital in 2024, down significantly from the 32 final closings and USD6.77 billion in capital raised in 2023. First-time fund managers continued to struggle. Deal-

StreetAsia reported only five debut South-East Asia focused funds closing aggregate proceeds of USD500 million in the entirety of 2024, while Pitchbook tracked ten funds closed by first-time managers.

Additionally, DealStreetAsia found that among the 49 funds that achieved an interim closing since 2021, nearly half have not provided any further updates on a final close, indicating a significant backlog of announced funds that may be undersubscribed. In October 2024, Peak XV, one of the largest VC firms focused on India and South-East Asia, announced that it would release its limited partners from USD465 million in prior commitments related to the USD2.85 billion fundraise it had disclosed in 2022. The firm also offered to reduce its management fees from 2.5% to 2% and its carried interest from 30% to 20%. Meanwhile, Openspace Ventures, which was reported to be raising a USD300 million fourth fund in early 2023, announced a final close at just USD163 million in November 2024. According to Pitchbook, VC funds that closed in 2024 had a median duration of 17.4 months, a slight decline from the 19.1 months required for funds closed in 2023, but the longest duration since 2015.

Despite the challenges, several notable investors successfully closed funds in 2024. In March 2024, B Capital announced the final closing of its second opportunities fund, totalling USD750 million. A few months later, Jungle Ventures reported an interim closing of USD250 million towards its targeted USD500 million fifth fund. Additionally, Unstuck VC, a venture studio led by a first-time manager, raised USD250 million in April 2024.

Concerns Around Internal Controls and Governance

The South-East Asia VC and founder community was shaken by news in early January 2025 that agritech unicorn eFishery – a standout of the Indonesia start-up narrative backed by an enviable roster of investors including Softbank, Temasek, Northstar and Peak XV – had terminated its senior leadership and was undertaking an internal investigation into financial irregularities. The scale and duration of the misconduct soon became evident: nearly USD600 million in inflated revenues in fiscal year 2024 alone, and further misreporting dating back as early as 2021. eFishery's impact extends far beyond the nearly USD1 billion in value that was virtually erased overnight for numerous top-tier investors. This incident, along with a number of less-publicised but equally concerning cases involving South-East Asian start-ups in recent years, has severely undermined the confidence and sentiment of VCs, their limited partners, potential acquirers, and strategic investors around the world. It has already had, and will continue to have, a significant and transformative impact on the way deals are structured and how start-ups are managed in this region.

In the aftermath of eFishery, we expect investors to approach deals with an even greater level of scrutiny, implement processes to ensure ongoing oversight, and introduce stricter measures to hold management accountable. As a result, start-ups and founders should prepare for a longer lead time to secure funding and a more comprehensive and costly due diligence process. Start-ups should also prepare for intensified negotiations on investor rights and management responsibilities, and a risk-shifting by VCs to protect their investments. These measures will not be confined to the immediate transaction – investors will likely require regular and

detailed financial reporting, which may require the involvement of independent third-party vendors, and seek remedial measures that extend beyond what has traditionally been regarded as standard in venture deals.

Investors have already began implementing more stringent transaction terms in 2023. While many of these remained outliers initially, some became more commonplace as 2024 progressed. Examples include:

- requiring founders to personally backstop warranties beyond the standard suite of *"fundamental warranties"*, including the accuracy of a company's financial statements and catch-all anti-fraud warranties concerning misrepresentations and omissions during due diligence;
- requiring founders to personally commit to certain ongoing covenants, such as implementing and complying with internal policies and procedures and disclosing interested-party transactions;
- imposing harsher consequences for breach of the aforementioned warranties and covenants, including requiring founders to personally indemnify investors and agree to *"bad leaver"* default terms that provide investors and/or the company the right to claw back vested founder equity at a discount;
- expanding bad leaver clawback terms beyond the founding team and management to bind all employees and service providers; and
- adopting strict banking policies that grant investor directors increased control and oversight over key bank account outflows.

Financial Sustainability Remains Priority

VCs and founders continue to prioritise unit economics and the pursuit of profitability. The pathway for start-ups to achieve product-market fit, showcase reliable monetisation strategies, and reach break even has been considerably shortened. Many companies that previously raised substantial funding rounds at high valuations are now approaching the end of their cash runway, despite cash preservation measures, and are in need of additional capital. Those that have not scaled to match their existing valuations face the difficult decision of either continuing to reduce their burn rate at the expense of growth or seeking further funding under unfavourable terms.

In 2023, the resetting of expectations regarding valuations, combined with investors' reluctance to reprice their positions and realise markdowns in their fund portfolios, led to a standstill in new deal-making. By contrast, investors in 2024 appeared more willing to reconsider valuations in order to facilitate transactions. The availability of capital from new investors has also significantly increased compared to 2023, when most focused their resources on supporting existing portfolio companies rather than exploring new opportunities. However, VCs are generally prioritising financially sustainable businesses with established products over start-ups with untested go-to-market strategies and ambitious projections.

Structured Rounds and Downside Protections

Convertible instruments featuring strict control covenants and default terms tied to financial and operational performance, which gained popularity among investors as a way to support existing portfolio companies facing challenges in raising new capital in 2023, have now emerged as a favoured option for investors. These instruments typically convert mandatorily upon a qualified equity financing that meets specific gross proceeds and valuation criteria, but are otherwise

optionally convertible into equity at maturity or upon certain events, such as an exit or a default. While these notes may offer added protection for investors because they rank senior to equity in priority of payout in the event of a dissolution or downside sale, they are accounted for as liabilities, which may increase a company's cost of borrowing and serve as a deterrent to further equity investment until they are converted or redeemed. Additionally, notes are often accompanied by warrants exercisable at a discount or nominal value, which typically trigger anti-dilution protections and can result in significant dilution to existing shareholders.

We continue to see a rise in funding rounds structured with both primary and secondary components. These rounds fulfil several purposes, including allowing new investors to purchase shares from earlier investors at a discount to the new round's valuation, thereby achieving a more attractive blended entry valuation. Additionally, they provide liquidity for earlier investors while enabling the company to raise fresh funding at a primary valuation higher than it might otherwise attract. This approach can help existing investors avoid a significant markdown in their investment and reduce, or entirely circumvent, the effects of anti-dilution adjustments.

Many of the more stringent pricing and downside protections that we observed in 2023 have, fortunately, become less prevalent in 2024. In the absence of truly distressed situations, investors have generally demonstrated restraint from demanding multiples and/or participation rights on liquidation preferences, imposing ratchet-based anti-dilution protections, or seeking forward-looking most favoured nation provisions. This reflects a recognition that future investors will almost certainly piggyback on such terms, potentially on a senior basis, negating any temporary advantage enjoyed by the investors who introduced them. It also signals that, although investors remain cautious and selective in the deployment of new capital, once a decision has been made to finance a company, they are adopting a longer-term perspective rather than concentrating primarily on immediate protections.

We have continued to observe a number of pay-to-play insider-led rounds throughout 2024 as securing new funding on acceptable terms remains challenging. Existing investors – often those who joined in more recent rounds at higher valuations – are willing to continue bridging their companies, but expect to be rewarded for their participation. Pay-to-play structures typically penalise non-participants by implementing a complete recapitalisation of preference shares into ordinary shares, with non-participating investors facing the risk of reduced or eliminated liquidation preferences, anti-dilution protections, and other preferential rights. In some instances, non-participants in a pay-to-play round also face *"cram down"* on their existing economics within the company, resulting in significant dilution of their equity stake.

Artificial Intelligence to the Rescue

AI-focused start-ups attracted considerable investment in 2024; however, most of this capital was directed toward companies operating in more mature venture markets such as the USA and Europe. Investors have become more discerning in their evaluation of start-ups claiming to develop novel AI solutions, targeting businesses that can provide customers with products that deliver consistent and measurable improvements in productivity and efficiency, without incurring excessive costs by relying heavily on expensive computing resources. Gunderson Dettmer's 2024 Venture Capital Report found

that these start-ups have shifted to primarily utilising two go-to-market strategies: (i) ready-made *"off-the-shelf"* vertical AI applications customised for sectors such as healthcare, finance, and human resources, and (ii) flexible, adaptive AI solutions that cater to customer needs, typically delivered through enterprise-grade professional implementation and customisation services.

Regulatory due diligence is an essential yet costly process when evaluating any investment in an AI-focused start-up. These companies must navigate a variety of intellectual property and privacy laws, many of which are constantly evolving as courts issue rulings on ongoing lawsuits. Start-ups that rely on proprietary datasets or customer data to train their models without implementing the necessary safeguards and policies risk facing challenges from regulators and third parties, which can lead to a rapid decline in value. Investors have increasingly demonstrated a preference for start-ups that not only demonstrate the ability to adapt to established regulations but also proactively develop a business model designed to accommodate upcoming regulations and pending court rulings.

Lack of Exit Liquidity Continues to Plague the Region

Concerns regarding the availability and viability of exits persisted throughout 2024. Some VCs have raised continuation funds to offer limited partners of existing funds some liquidity through the buyout of select portfolio positions. We have also seen VCs with diversified investments across synergistic sectors actively pursue a strategy of consolidation, identifying candidates among their existing portfolio companies that could be combined to strengthen balance sheets and capture market share. This approach may be used to extend cash runway by reducing redundancies in overhead cost, present a more attractive package for potential acquirers, and better position a company to explore debt financing. Exit activity is anticipated to accelerate in 2025, as more funds approach the end of their cycles and general partners face pressure to accept portfolio markdowns in order to attract buyers.

Public listings on more established international exchanges continue to remain out of reach for many start-ups in the region. The heavy emphasis on financial performance, profitability and consistent top-line growth may mean that more start-ups in the coming years will achieve the fundamentals required to pursue a successful listing. However, regional exchanges continue to be viewed by investors as lacking the diversity of participants, global investor base and market cap to generate reliable trading liquidity for a viable exit.

Buyouts by private equity sponsors and trade sales to strategic buyers remain the most popular path to liquidity. While private equity buyout activity saw an uptick in 2024, most of these transactions involved established companies in traditional industries rather than venture-backed start-ups. Pitchbook tracked only three acquisitions of regional VC-backed start-ups valued at over USD50 million in the entirety of 2024, including PingSafe's USD100 million acquisition by US-based cybersecurity company SentinelOne, Dekoruma's USD71 million acquisition by Indonesia-based e-commerce company Blibli, and Skuad's USD61 million acquisition by US-based fintech company Payoneer.

Alternatives to Traditional Venture Capital

Growth-stage start-ups are increasingly turning to venture debt and traditional debt as a valuable source of capital due to the ongoing lack

of growth equity financing available in South-East Asia. As companies increasingly prioritise profitability, capital from small-cap private equity investors and private credit providers has become more accessible to start-ups. The venture arms of large corporates, which have traditionally invested strategically in start-ups to access innovative technologies, market insights, and rights of first offer or refusal for collaborations or partnership opportunities, have also remained active in the market. The relatively lower urgency among corporate VCs to secure financial returns through an exit presents an appealing proposition for founders who are under pressure from VCs to achieve liquidity.

Venture builders and start-up labs also serve as important contributors to the venture ecosystem in Singapore. However, traditional VCs assessing a venture-built start-up often have concerns about the company's ability to attract and retain high quality talent. While such start-ups may offer an experienced and highly qualified management team, they also tend to operate at a higher cash burn rate, and without proper incentive structures in place, the key contributors may be inclined to depart for other lucrative opportunities.

2025 and Beyond

Despite the headwinds, South-East Asia maintained its upward trajectory in digital adoption, with internet penetration on track to exceed 80% and internet users comprising nearly two-thirds of the region's total population, according to the 2024 e-Conomy SEA Report published by Google, Temasek and Bain & Co. Certain trends in 2025, including an expected reduction in interest rates and gradual return of foreign investors to the region, are expected to provide further tailwinds for South-East Asian start-ups. The accelerated adoption of AI tools, in particular, is expected to greatly aid start-ups in enhancing customer service, optimising costs, and addressing inefficiencies, allowing them to reallocate resources towards development and innovation.

Finally, the South-East Asia talent market is showing equally positive signs of catching up with more mature technology markets. In a recent H1 2025 State of the Markets report published by Silicon Valley Bank, South-East Asian nations, led by Singapore, Vietnam, the Philippines and Indonesia, represented four of the eight fastest growing markets for tech talent, as indicated by the number of new developers registered on the GitHub platform from 2023 to 2024. In addition to technical talent, alumni of successfully exited tech companies such as Grab, Gojek, Tokopedia and Sea Group, among others, continue to reinvest their skills and capital into the South-East Asia venture ecosystem, contributing to hundreds of successfully funded new start-ups.

The first quarter of 2025 has shown some promising signs of a rebound, but whether the momentum continues throughout the year remains to be seen. Start-ups that have demonstrated resilience through the challenges of 2023 and 2024 will be well positioned to capitalise on opportunities when the market eventually recovers. However, founders must continue to prioritise the execution of a sustainable monetisation and profitability model while pursuing strategic growth.

SOUTH KOREA

Law and Practice

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1. Trends

1.1 VC Market

In 2024, venture capital investments in Korea amounted to KRW11.9 trillion, with an increase of 9.5% compared to the previous year. The number of companies attracting venture investments also reached 4,697, the highest number ever recorded in Korean venture investment history.

The Information and Communication Technology (ICT) sector remained the most attractive, with a 38% increase compared to the previous year, maintaining the upward trend observed in the prior period. Following ICT, substantial investments were made in the bio/medical and electrical/mechanical/equipment sectors.

This year, three companies that attracted investments of KRW1 billion or more were all from the ICT sector: ETECH SYSTEM (KRW180 billion), which operates a cloud business, Rebellion (KRW165 billion), an AI semiconductor start-up, and Upstage (KRW100 billion), a generative AI development start-up. ETECH SYSTEM attracted investment solely from SG Private Equity, while Rebellion gained attention for receiving investment from Aramco, the world's largest energy and chemical company, marking the first such investment as a venture company in Korea.

1.2 Key Trends

According to the 2024 Venture Capital Market Brief, published by the Korea Venture Capital Association, new funding for venture capital firms in 2024 fell by approximately 15.4% compared to 2023, while new investments by venture capital firms increased by 22.9% year-on-year. In addition, a majority (54.4% to be exact) of the investment recovered by venture capital firms was recovered through third-party sales, whereas 30.6% of such investments were recovered through IPOs. While the number of IPOs increased and the proportion of third-party sales declined in 2023, 2024 saw a slight reduction in IPO activity, accompanied by an increase in the proportion of third-party sales.

1.3 Key Industries

According to the 2024 Venture Capital Market Brief, published by the Korea Venture Capital Association, the ICT service sector accounted for the highest share of VC investments at 31.3%, followed by the bio/medical sector at 16.1%. Building on the trends observed in 2023, there has been a notable increase in investor interest in *"deep tech"* start-ups, particularly in the AI semiconductor and robotics industries. This has led to a substantial rise in investments in the ICT services, ICT manufacturing, and electrical, mechanical, and equipment sectors. Conversely, investments in the film, performance, and music industries have experienced a significant decline.

2. Venture Capital Funds

2.1 Fund Structure

In Korea, venture capital funds are commonly established and operated in the form of a partnership, trust or corporation. Each form of entity is subject to different regulations, with a different set of incorporation requirements, and there are standardised versions of incorporation documents for each form of entity. For example, a venture capital fund established as a partnership requires an investment partnership agreement to be executed by the partners, whereas a venture capital fund established as a trust requires a trust agreement to be executed with a trust company, an investment agreement to be executed between the general partner and limited part-

ners, and articles of association for the management of the fund. Lastly, a venture capital fund established as a corporation must have in place the articles of incorporation that regulate matters relating to management of the fund.

2.2 Fund Economics

Fees payable to fund initiators/managers/principals (*"Fund Principals"*) are usually divided into (i) management or operating fees, and (ii) carried interest. Carried interest is determined on a case-by-case basis, and as a general matter, it is customary for approximately 20% of the excess profit to be paid as carried interest if the internal rate of return (IRR) exceeds a certain threshold, normally 7–8%.

The following key terms pertaining to the relationship between Fund Principals and investors are included in the standardised form of the investment partnership agreement published by the Korea Venture Capital Association, which form is widely used in practice:

- investors' right to make inquiries and receive responses from Fund Principals;
- investors' right to receive periodic financial reports from Fund Principals;
- Fund Principals' obligation to keep fund assets under a trustee's custody and control; and
- designation of *"key persons"* who may be replaced only through consultation with (or with consent from) the investors.

2.3 Fund Regulation

Domestic venture capital funds are regulated under the Venture Investment Promotion Act (VIPA), which was enacted and came into effect in 2020. VIPA brings together regulations on venture-related investments that used to be dispersed across several pre-existing pieces of legislation, including the Act on Special Measures for the Promotion of Venture Businesses and the Support for Small and Medium Enterprise Establishment Act. Compared to previous regulations, VIPA partially relaxes regulations on investment in venture companies in order to promote such investments by private investors. In addition, to cultivate an environment favourable to venture capital investment that conforms to global standards, VIPA allows for the execution of a simple agreement for future equity (SAFE) with a venture company. Such agreements, though widely used in venture capital investment in the United States, were not previously recognised under Korean law. In addition, the issuance of convertible notes by venture companies has also been permitted.

2.4 Particularities

In Korea, investment of government funds in venture companies and start-ups, through the formation of a fund of funds, and with the aim of fostering the growth of venture companies and start-ups, is active. A fund of funds is a parent fund that invests in one or more funds formed by private venture capitalists aiming to invest in SMEs and start-ups. A fund of funds is formed with government funds sourced from the Ministry of SMEs and Start-Ups, the Korea SMEs and Start-Ups Agency, the Ministry of Culture, Sports and Tourism, the Korean Intellectual Property Office and other government departments and agencies. A fund of funds invests in other funds established using venture capital, and the latter invests in venture companies/start-ups. In most cases, the main investment by a particular fund of funds will be restricted to a particular sector.

3. Investments in Venture Capital Portfolio Companies

3.1 Due Diligence

In most cases, venture capital fund investors conduct a level of due diligence similar to that conducted for a typical M&A transaction. In the case of targets that obtain venture capital investments, funding typically occurs over multiple rounds, so at each stage, it is necessary to take a close look at the terms of the investment agreement(s) executed in the previous round(s). In addition, due to the nature of venture capital investments, target companies are often start-ups that are tech-focused or based on online platforms, so IP and personal information protection are often key areas of focus in due diligence.

3.2 Process

It usually takes two to four months (including due diligence) for each round to be closed. However, it is difficult to determine a uniform timeline because the progression of a deal differs for each investment, depending on various factors and requirements (the size of the investment, whether existing investors participate in the new round with multiple investors, whether joint counsel is used, whether the consents of all existing shareholders are required, etc).

3.3 Investment Structure

Venture capital firms prefer to invest in redeemable convertible preferred stock (RCPS), which is a type of preferred stock with both redemption right and conversion right, or convertible preferred stock (CPS), which is a type of preferred stock with conversion right only, at an early stage of a company's development. In addition, venture capital firms often make investments in the form of convertible bonds or bonds with warrant. Securities with these characteristics are preferred at an early stage because they provide better opportunities to (i) secure exit by providing the holder with a priority in payment of distributions in the event of liquidation or occurrence of a redemption-triggering event, and (ii) realise the upside potential of the target company with the right to convert securities into common stock.

3.4 Documentation

Historically, there was no standardised form of agreement for venture capital investment in South Korea. As a result, in many cases (especially if start-ups did not hire professional legal advisors, which was often the case), investment agreements and other legal documents were often poorly drafted or created by the investors themselves without assistance from lawyers. There was therefore a demand for improvement in the quality of investment agreements, and, as a result, the Korea Venture Capital Association, in collaboration with the Korea Business Angels Association and the Korea Accelerator Association, prepared and published a standard set of venture investment agreements to be used for different stages of investment (early, mid-term, and late investments). At present, venture capital firms in Korea tend to enter into investment agreements by using these standardised forms, which are then customised to meet the needs of a given investment.

3.5 Investor Safeguards

In general, venture capital firms try to secure downside protection through liquidation/dividend distribution preferences, conversion rights (including customary adjustment to conversion price), redemption rights, anti-dilution protection, consent rights over material matters, put options against the major/controlling shareholder of the target company, and information rights.

Both anti-dilution protections and pre-emption rights are frequently used. Venture capital firms may secure the right to consent to the issuance of securities, or include the issuance of securities at a price lower than their subscription price as a ground for adjusting the conversion price, or secure the right to subscribe for new shares issued by the company pro rata to their relative shareholding ratios (*"pre-emption right"*).

3.6 Corporate Governance

As a general matter, the following rights are usually granted to venture capital investors in relation to the company's corporate governance.

Right to Appoint Director(s)

The venture capital investor will have the right to nominate a certain number of directors, and the parties to the investment agreement with the investor (typically the target company and the largest shareholder) will be contractually obliged to appoint person(s) nominated by the investor as director(s) by voting accordingly at a general meeting of shareholders. In Korea, directors of a company are listed in a company registry (which is a publicly available document), and there is no nationality or residency requirement for directorship. Also, investors often seek and obtain the right to nominate an observer to the board of directors. For reference, in Korea, an observer is, unlike a director, a de facto position, which has no legal basis in the Korean Commercial Act.

Consent Rights Over Material Matters

The type of material matters over which the venture capital investor has a consent right may vary depending on the negotiation of the parties involved, but in general, they usually include amendments to the articles of incorporation, changes in capital structure, fundamental changes in the company's organisation (such as dissolution, liquidation, merger, division, division and merger and business transfer), issuance of new securities, grant of stock options, and significant transactions (ie, those with a value exceeding a certain threshold).

Information Rights

The right to receive important financial/operational information of the company, and the type of information that the investor has the right to receive may vary depending on the negotiations of the parties involved, but they often include financial statements, business plans and budget plans at certain intervals.

3.7 Contractual Protection

The representations and warranties, covenants, and indemnity clauses and mechanisms observed in a financing round are similar to those included in an agreement for a typical M&A contract. Certain caveats to this are set out below.

Representations and Warranties/Covenants

A venture capital firm may not make representations, warranties, or covenants in the investment agreement, or make only fundamental representations and warranties (eg, incorporation or due authorisation) and basic covenants (eg, confidentiality obligations). However, if the investor is required to obtain any particular regulatory approvals (eg, clearance of merger filing or foreign exchange filing) in relation to the execution and performance of the agreement, the agreement will include representations, warranties and/or covenants related to obtaining such approvals. Target companies usually provide a fairly detailed set of representations and warranties relating to their operation and businesses, including financial statements, labour, intellectual property, real properties, etc.

Recourse for Breach/Violation

If the target company breaches any of its representations, warranties or covenants, in the case of an investment in RCPS, the company may be obliged to effect an early redemption of the RCPS as a result of the breach. In such cases, the penalty rate will apply in addition to the default interest rate until the redemption amount is fully paid. In addition, the company may be required to pay penalties to the venture capital investor in addition to compensation for damages resulting from the breach. In some cases, the investor may become entitled to exercise a default put option against the largest shareholder in the event of a breach.

4. Government Inducements

4.1 Subsidy Programmes

There is no meaningful incentive programme for investors who make equity investments in SMEs and start-ups in Korea; instead, the Korean government provides support through providing funds for (i) investments in funds of funds and (ii) the expansion of investment in SMEs and start-ups.

A fund of funds is a fund funded by the Korean government that is mainly intended for investment in certain sectors. Specifically, a fund of funds is managed by Korea Venture Investment Corp., an institution established by the Korean government in accordance with VIPA. Korea Venture Investment Corp. selects a general partner, causes the general partner to form a fund with funding received from a fund of funds and capital received by the general partner from other investors, and the fund then makes investments in a certain sector. The investment targets of a fund of funds will vary depending on the fund in question, but they mainly include early-stage start-up companies, privately held SMEs and venture companies, and there are cases in which concentrated support is given to investment in a particular sector as needed.

4.2 Tax Treatment

Key characteristics of tax treatment relevant to venture capital investments are as follows:

- Tax Benefits at the Investment Stage: If a resident or a domestic corporation (other than venture investment companies) invests in start-up companies, venture companies, private equity funds specialising in start-ups and venture companies, or a start-up investment association, a certain percentage of the investment amount is eligible for a tax deduction (for residents) or tax credits (for domestic corporations). However, tax benefits are given only for investment in new stock within a certain period of time, and no special tax benefits are allowed for investment resulting from the sale of existing shares.
- Tax Benefits at the Exit Stage: In principle, capital gains tax is levied when a resident transfers shares, but a tax benefit is granted to exempt capital gains tax on investment in certain venture companies and venture investment companies.
- Others: Special measures exist for the exemption from corporate income tax if a venture investment company invests in stock of certain venture companies.

4.3 Government Endorsement

As discussed above, the Korean government uses the fund of funds structure to create an environment favourable to venture investment in the private sector and to promote investment linked to innovation, especially in SMEs and venture companies. Although there are no restrictions on the investment methods of a fund of

funds, a fund of funds is often used in equity financing for innovative technology businesses, start-up companies, and privately held SMEs. In this way, the government indirectly supports equity financing activities.

5. Employment Incentives

5.1 General

The most frequently used method to procure the founders'/key employees' long-term commitment is the grant of stock options. Under the applicable laws and regulations of Korea, officers or employees must have worked at a company for a minimum of two years to exercise their stock options. A separate stock option agreement can be executed to require a longer period of service as a condition for exercising all or part of the stock options.

In recent years, the grant of restricted stock units (RSUs) has been on the rise. An RSU refers to the right to receive treasury shares held by the company if certain conditions are met. In this case, a method typically used is the incremental grant of shares upon the fulfilment of conditions linked to the period of service.

Effective 10 July 2024, an amendment to the Special Act on the Promotion of Venture Businesses (*"Venture Business Act"*) was enacted, facilitating the use of restricted stock units (RSUs) by venture companies. To grant RSUs, a venture company must acquire treasury shares as the source of funding. However, under the Korean Commercial Code, the acquisition of treasury shares was previously limited to the extent of distributable profits, which posed a practical challenge for early-stage venture companies, which often struggle to generate profits. The recent amendment to the Venture Business Act now permits venture companies to purchase their own shares, even without distributable profits, provided that such purchases do not result in capital impairment. This change is expected to promote more active utilisation of RSUs by venture companies moving forward.

5.2 Securities

The most commonly used method to align the interests of founders/key employees with the interests of the company is the grant of stock options. A recent development is the grant of RSUs to this end. In both cases, it is common to stipulate that the conditions for exercising/granting stock options/RSUs are linked to the period of service. To take stock options as an example, when a stock option with the right to receive a total of 100 new shares is granted, a condition attached can be that the stock option with respect to the first 50 shares can be exercised after two years of service, and the stock option with respect to the remaining 50 shares can be exercised after four years of service. The conditions for exercising/granting stock options/RSUs can also be linked to other performance indicators.

5.3 Taxation of Instruments

Under Korean tax laws and regulations, in principle, the difference between the market price of shares at the time of exercising the stock option and the exercise price is taxed as earned income (at the rate of up to 49.5%), but special measures provide for tax benefits with respect to stock options granted to officers and employees of a venture company registered with the Ministry of SMEs and Start-Ups. These special measures include:

- a tax exemption (of KRW200 million per year);
- payment in instalments (for five years); and

- the application of capital gains tax (at the rate of 27.5%) at the time of transfer of shares acquired through the exercise of a stock option, rather than tax on earned income at the time of exercising the stock option.

5.4 Implementation

If a company already has an employee incentive programme in place at the time of due diligence, or if a company plans to implement such programme during the investment process, such programme should be recognised as a dilution factor and reflected in the number of shares to be acquired before proceeding with the investment. In contrast, if an employment incentive programme is to be introduced after the venture capital investment has already been made, the programme would be subject to the investor's right to consent.

6. Exits

6.1 Investor Exit Rights

Typically, an investor exits through an IPO or third-party sale. Depending on the specific situation at the time of exit, the investor can choose either of these options, or consider a dual track by pursuing both options at the same time. In addition, RCPS investors may consider exercising their redemption rights, or they may exercise a put option, if such options are provided in their investment agreements.

In Korea, when an investor makes a venture capital investment, it is not common for all shareholders to enter into a shareholders' agreement; instead, it is more customary for each investor to execute an investment agreement only with the company and the largest shareholder/founder without other shareholders. As a result, there is often no one-size-fits-all contractual clause applying to the relationship among all shareholders in the event of an IPO or trade sale. More generally, each shareholder is entitled to exercise certain rights (eg, the right to demand a qualified IPO to be effected within a certain time period and/or a put option) against the company and/or its major shareholder/founder.

It is not common for an investment agreement executed by a Korean venture capital investor to include an agreement to limit the disposal of venture capital investors' shares, but the investor may sometimes be deprived of certain rights granted under the investment agreement (eg, consent right, consultation right or right to nominate directors) if their shareholding percentage in the company falls below a certain threshold.

6.2 IPO Exits

According to the 2024 Venture Capital Market Brief, published by the Korea Venture Capital Association, 54.4% of the investments recovered by venture capital investors were recovered through third-party sales, whereas 30.6% of investments were recovered through IPOs. Many start-ups have an IPO as their ultimate goal, and the average time for start-ups to successfully go public is generally thought to be about 10 to 14 years. The reason why it takes so long is not due to any legal hurdles, but because it takes a significant amount of time, commercially and practically, for a start-up to grow into a company that satisfies the qualitative and quantitative requirements to pass the listing eligibility review by the Korea Exchange (KRX).

Since KRX listing is relatively attractive in terms of initial cost and maintenance costs, almost all Korean start-ups established under Korean law choose to be listed in Korea, unless there is a particular need to raise capital overseas. As of 2024, the proportion of venture capital-backed

companies listed on the KOSDAQ is 63.1%, which is an increase of 8.7 percentage points from 54.4% in 2023.

Recently, the Korean financial authorities have restructured the IPO system to prevent the sharp decline in stock prices of newly listed companies and protect individual investors by expanding the allocation of IPO shares to institutional investors with lock-up agreements. Under the revised regulation, effective in March 2025, more than 40% of the institutional investor's volume (or 30% if the securities registration statement is filed by the end of 2025) must be prioritised for institutional investors with lock-up agreements. If the increase in lock-up for institutional investors leads to a reduction in the circulating stock volume, it may result in greater stock price volatility, making it more difficult for venture capitalists to recover their investments. This could also impact new investments made by venture capital firms, as they often rely on capital recovery to secure investment resources.

6.3 Pre-IPO Liquidity

Recently, an atmosphere of active secondary market trading has taken hold in Korea. Due to the recent downturn in the IPO market, investors' need for exits through secondary sales has increased. In addition, demand for investment through the secondary market is also increasing, as funds of funds have recently allocated their funding to funds that invest through secondary trading.

As secondary sales are often powered by funds of funds in Korea, the most important aspect of a secondary market deal is the price negotiation between the seller and the buyer. The seller fund needs to meet the target rate of return, while the buyer fund wants to keep the purchase price low, considering the expected price at the time of exit.

Warranty and indemnity (W&I) insurance policies are sometimes used in these secondary market deals, because the seller is a fund that was not responsible for the operation of the target company and does not want to provide representations and warranties on such matters, nor the corresponding indemnity. Even when the seller is willing to provide such representations and warranties and indemnity, the seller may have been dissolved or liquidated by the time that the buyer wants to exercise this right.

7. Regulation

7.1 Securities Offerings

The KRX has three markets: KOSPI, KOSDAQ, and KONEX. KOSPI is the market for blue-chip conglomerates (a company with sales of KRW100 billion or more and that satisfies certain criteria including a base market capitalisation of KRW200 billion or more and equity of KRW150 billion or more). KOSDAQ is the market for *"medium-sized"* companies (ie, a company with KRW5 billion or more in profit from continuing operations before corporate income tax, a base market capitalisation of KRW30 billion or more, and sales volume of KRW10 billion in the most recent fiscal year). KONEX is a market for SMEs.

The English versions of the KOSPI Market Listing Regulation, the KOSDAQ Market Listing Regulation, and the KONEX Market Listing Regulation are available here. In addition, the listing requirements for each market are summarised in English here.

7.2 Restrictions

The restrictions that, among others, may apply to foreign investment in Korea are set out below.

Sectors in Which Foreign Investment Is Restricted

There are certain sectors where foreign investment is prohibited. These sectors include postal services; central banks; legislative agencies; administrative agencies; courts; prosecutors' offices; police; fire departments; educational institutions (including early childhood education institutions, primary schools, middle schools, high schools and universities, graduate schools, and special schools); art, industrial, professional, political, religious, labour, and environmental movement organisations; nuclear power generation businesses; and radio and terrestrial broadcasting businesses.

The ratio of foreign investment in companies in certain sectors may not exceed a certain threshold. For example, the foreign investment ratio must be less than 50% in companies engaged in beef cattle breeding, air transportation, and magazine and newspaper publishing.

A detailed list of prohibited or restricted areas is published annually by the Ministry of Trade, Industry and Energy (MOTIE).

Government Approval

A prospective foreign investor in certain restricted sectors must obtain approval from the relevant government agency:

A prospective foreign investor in a defence company must obtain prior approval from MOTIE.

A foreign investor wishing to invest in a company that possesses *"national core technology"* or to transfer *"national core technology"* overseas must obtain prior approval from MOTIE. National core technologies include those related to semiconductors, displays, batteries, automobiles/railways, steel, shipbuilding, nuclear energy, information and communication, and biotechnology. The list of national core technologies is published by MOTIE.

Recently, the Korean government has taken steps to strengthen the protection of national core technologies. Some provisions of the Foreign Investment Promotion Act, effective from 28 July 2016, require foreign investors acquiring control over companies managing defence industry companies, where there are concerns that it may affect the stable supply of defence materials, to undergo a review by the Foreign Investment Review Committee. Also, a legal amendment (Act on Prevention of Divulgence and Protection of Industrial Technology) has been passed, which includes regulations such as:

- requiring prior approval from the Ministry of Trade, Industry, and Energy (MOTIE) for foreign mergers, acquisitions, and joint ventures involving companies holding national core technologies, including those controlled by foreign individuals or foreign companies;
- applying stricter criteria when reviewing M&A transactions involving companies holding national core technologies;
- expanding the definition of industrial technology leakage and infringement to include unauthorised leakage or use of industrial technologies outside designated locations;
- increasing the punitive damages limit from three times to five times the damage amount; and
- raising fines for individuals involved in technology leakage when they are aware that the technology will be used overseas.

These changes are set to take effect on 22 July 2025. Therefore, potential foreign investors should closely examine the changes due to the strengthened sanctions resulting from the legal revisions.

Other Sectors

Other than the areas outlined above, foreign investment in Korean companies is generally not restricted. A foreign investor will generally be required to file an investment report or securities acquisition report with the Korea Trade-Investment Promotion Agency or a foreign exchange bank prior to the closing of its investment. The specific type and procedure for filing vary depending on the type of equity acquired and the amount of investment, but such reports are generally considered to be a routine matter.

SWEDEN

Law and Practice

Contributed by:
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Gernandt & Danielsson Advokatbyrå KB has an established reputation as one of the leading law firms in Sweden. The firm has approximately 100 lawyers in Stockholm and has a strong international practice. It provides advice to both Swedish and international clients. The firm regularly works on cross-border transactions and has close working relationships with leading law firms in all Scandinavian jurisdictions, elsewhere in Europe, the UK and around the world. Gernandt & Danielsson advises both investors and venture capital-backed companies in all types of venture capital matters, including equity investments, growth financing, fund formation, joint ventures and exit processes such as trade sales and IPOs as well as advising management of portfolio companies. The team includes a strong bench of leading individuals, specialised in various areas such as M&A, capital markets, private equity, venture capital, fintech, regulatory, artificial intelligence, employment and GDPR.

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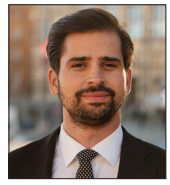

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GERNANDT & DANIELSSON

1. Trends

1.1 VC Market

Sweden, long recognised as the Nordic region's most active and mature venture capital ecosystem, experienced a slow start in 2024 and a decline in funding by nearly 50% compared to 2023. Deal activity remains significantly below record levels seen in 2021–2022 (according to PitchBook data). However, signs of stabilisation and recovery began to emerge in the second half of 2024 and is continuing into 2025.

- Fundraising: The fundraising market has remained active and investor confidence in the Swedish ecosystem is visible through several successful fund closes in 2024. Norrsken VC Fund II (co-founded by Klarna co-founder Niklas Adalberth) closed at EUR320 million, making it the largest early-stage generalist impact fund in Europe. Creandum VII, one of the region's most established early-stage investors, closed at EUR500 million, placing it amongst the top ten fundraisings in Europe in 2024. These dry powder reserves are expected to fuel early-stage activity across Sweden in 2025 and beyond, especially in purpose-driven tech.
- Financing: Despite the general slowdown, a number of noteworthy financing rounds took place on the Swedish market in 2024. Stegra (formerly H2 Green Steel), a company aimed at revolutionising the *"hard-to-abate industry"* (starting with steel) by producing green hydrogen and green iron to replace fossil fuels like coal and natural gas in the production process, raised EUR4.5 billion in equity and debt as well as received state aid of SEK1.2 billion (amounting to approximately EUR105 million at the time), making it one of Europe's largest-ever climate tech financings. Aira, a provider of clean energy-tech solutions with intelligent heat pumps at its core business, raised a EUR243 million Series B round. Qvantum Energi, a company focusing on developing and manufacturing sustainable heat and cooling solutions, raised a EUR108 million Series C round. Heart Aerospace, a hybrid-electric airplane maker with an aim toward sustainable regional air travel, secured USD107 million in its Series B round. In early 2025, Neko Health, a preventative healthcare technology company co-founded by Daniel Ek (Spotify), closed a USD260 million Series B round, and evroc, which is creating a sovereign hyperscale cloud and AI infrastructure, closed a USD55 million Series A round, marking it one of Europe's largest Series A financing rounds in the tech sector. These deals reflect deepening conviction in climate and health-oriented technologies, but also continued support for the tech sector.
- Exits: Exit activity remained subdued on the Swedish venture capital market in 2024. A few exits occurred but nothing comparable to landmark exits in previous years. In 2024, Mastercard's acquisition of fintech start-up Minna Technologies (at unclosed value) as well as Norvestor's (a Nordic private equity fund) acquisition of Wint at a value of EUR44 million are two of several exits so far.
- IPOs: While the Swedish IPO market has recovered from the all-time lows during 2022 and 2023, the market has not experienced any significant listing by venture capital-backed companies in the last 12 months, except for Cinclus Pharma and GreenMerc in June 2024, as well as Yubico's de-SPAC listing in 2023 and subsequent uplisting to the main market at Nasdaq Stockholm in 2024 (without any new shares issued). One of the most hyped IPOs of a Swedish venture capital-backed company during 2025, is the IPO of the Swedish fintech company Klarna in

the US, which was expected during H1 2025 but, at the time of writing, has been postponed due to market volatility and valuation uncertainty.
- Bankruptcy: In March 2025, Northvolt filed for bankruptcy proceedings in Sweden (after a Chapter 11 filing in the US in November 2024), after securing over USD15 billion in funding since its founding, including a USD5 billion green loan in early 2024. Northvolt's collapse leaves Stegra as the bellwether for climate tech in Europe and has prompted broader questions around the viability of capital-intensive gigafactory ventures.

1.2 Key Trends

Following the valuation peaks during the record years of 2021–2022, the beginning of 2023 proved challenging for many Swedish start-ups. A combination of higher interest rates and geopolitical uncertainty led to a contraction in the availability of venture capital, resulting in a subdued fundraising climate, save for start-ups within clean and climate tech with Stegra (formerly H2 Green Steel) taking pole position in 2023 with its EUR1.5 billion financing from an investor group led by Altor, CIC, Hy24 and Just Climate.

While there was optimism at the outset of 2024, driven by expectations of interest rate reductions and market recovery, conditions remained constrained. Investors continued to focus on the increased cost of capital, whereas many founders remained anchored to prior-cycle peak valuations. This disconnect contributed to a continuation of the trends observed in 2023, with founders favouring convertible instruments and bridge financings over a down round.

As a result of the continued challenging financing climate during 2024, many investors shifted their focus from primarily assessing the potential of rapid growth, to also include sustainable growth, profitability and a clear exit route in the equation. The emphasis is now more on business models that balance revenue generation with long-term viability, predominately in sectors such as fintech and software as a service (SaaS), where the previous mindset of *"growth at all cost"* is being replaced by more strategic approaches. At the same time, the LPs of venture capital funds are becoming increasingly more demanding, wanting to see actual returns on their investments rather than being satisfied with a hypothetical figure derived from the most recent funding round.

Despite these pressures, the second half of 2024 and first quarter of 2025 saw a clear uptick both in fundraising activity and valuations, as more companies returned to the market and investor appetite improved. Foreign investors were further incentivised by the weak Swedish krona, enhancing the appeal of Swedish investments. There has also been a noticeable shift amongst investors preferring to deploy their capital in early-stage companies which are less capital-intensive and require less frequent capital injections, such as fintech and SaaS. This said, start-ups within the deep tech segment have seen a rise in both number and size of investments during 2024 despite those companies requiring substantial capital before reaching the commercial phase and seeing any meaningful revenue streams. This could be seen as an indication of investors' willingness to support groundbreaking impact technologies which, while capital-intensive, benefit from a clear competitive advantage due to high technological barriers to enter the segment.

Another important and noticeable trend during 2024 was Sweden's progression towards pro-

moting diversity within the start-up ecosystem, where 15% of all venture capital funding was received by female-led companies – one of the highest in Europe (according to an article published by Tech.eu in January 2025).

1.3 Key Industries

Sweden, with its mature venture capital ecosystem and reputation as *"unicorn factory"*, continues to foster and host a significant number of high-value start-ups, particularly in the technology sector. In 2024, Swedish tech companies raised close to 8.4% of all of the European tech funding, placing Sweden second in total funds raised across Europe (up from fifth place in 2023). This underscores the enduring strength and global competitiveness of Sweden's tech-driven innovation landscape and the continued importance of this industry in Sweden.

Traditional verticals such as fintech, healthtech and SaaS remained leading drivers of the Swedish VC activity in 2024. They were joined by a cohort of companies in climate tech, clean tech, transport and energy, which continued to attract investment despite broader macroeconomic headwinds. Emerging industries such as artificial intelligence (AI), deep tech, and sustainability are also gaining momentum, in line with the global venture trends, as well as Sweden's strong R&D-driven innovative culture.

Sweden's innovation credentials remain robust; it ranked second in the World Intellectual Property Organisation's (WIPO) Global Innovation Index and was among the top ten countries globally in patent filing.

Deep tech – encompassing fields such as advanced computing, AI, infrastructure, energy systems and synthetic biology – continues to play an increasingly important role in the Swedish venture ecosystem. These companies, often rooted in fundamental scientific or engineering breakthroughs, typically require significant capital and longer development cycles before reaching commercialisation. Despite this, Sweden has seen sustained investor interest in deep tech, aided by the country's world-class research infrastructure, top-tier universities, and a legacy of technological advancement.

A number of Swedish venture firms have dedicated arms or funds focused on impact and deep tech investing, and there is a growing number of investors demonstrating higher risk tolerance in return for the potential of transformative returns. That said, a funding gap persists at the scale-up and growth stages for deep tech ventures, reflecting broader trends across Europe.

Sweden's 2023 accession to NATO and heightened commitment to defence spending has generated increased attention to dual-use technologies – those with both civilian and defence applications. While this segment is still nascent and not expected to become a primary driver of Swedish VC activity in the near term, investor appetite is clearly shifting. A growing number of Swedish dual-use start-ups have begun attracting early-stage capital as the national focus on defence innovation, security and strategic autonomy gains momentum.

A distinction can be drawn between industries that continue to attract successive rounds of financing (such as deep tech, AI and climate tech), and those that see more frequent exits, particularly via trade sales or public listings. For example:

- fintech and SaaS companies remain prominent among VC-backed exit activity, given

their shorter time to market and well-defined acquisition pathways;
- deep tech and climate tech sectors, while vibrant in terms of early- and mid-stage funding, tend to have longer holding periods and fewer short-term exits, due to their complex R&D cycles and capital intensity.

2. Venture Capital Funds

2.1 Fund Structure

In Sweden, venture capital funds typically use limited liability companies (*aktiebolag*). The ownership of the fund is made up of passive investors, as well as the fund managers (which manage the fund's daily operations, including leading investment decisions, formulating the strategy and engaging with the portfolio companies). The investment committee (which is usually comprised of senior partners and top executives of the fund) is typically responsible for ultimately approving investments and exits in accordance with the fund's strategy.

Typically, investments in a Swedish venture capital fund are made by subscription of preference shares (ie, equity investment). Within such framework, the participation is governed by a shareholders' agreement. It is not unusual that certain funds also allow participation through equity-like loans in order to accommodate varied needs of investors from different jurisdictions. In case a venture capital fund allows participation through debt, the participation is usually governed by a debenture agreement (with substantial similarities to that of a shareholders' agreement).

Certain investors may also request to enter into side letters to address specific needs including as a result of a fund being backed by investors demanding certain rights applicable also in relation to the underlying portfolio companies (eg, information and/or inspection rights).

2.2 Fund Economics

In Sweden, fund initiators, managers and/or principals (collectively referred to as *"Fund Principals"*) typically participate in the economic upside of a venture capital fund through a combination of the following mechanisms.

- Management fees: Fund principals typically earn management fees, which are a percentage of the committed capital or assets under management. This fee, which is typically between 1.5–3%, compensates them for the operational and administrative costs of managing the fund.
- Carried interest: The primary source of upside for fund principals is through carried interest. This is usually structured as a percentage (typically between 20–30%) of the fund's profits via a European waterfall (whole of fund model).
- Fund commitment: Fund principals typically invest their own capital (typically between 2–4%) into the fund, either as direct investors in the fund or indirectly via co-investment vehicles. This serves to align interest with the investors and satisfy expectations of *"skin in the game"* and enabling them to benefit from the fund's overall success.
- Direct co-investment opportunities: Fund principals may also have the right to participate in direct co-investments alongside the fund in specific portfolio companies, enabling them to share in the potential upside of successful investments.

These mechanisms ensure that fund principals are incentivised to maximise the fund's performance, aligning their interests with the inves-

tors and promoting effective management of the fund's investments.

2.3 Fund Regulation

Swedish venture capital funds are typically regulated under the Alternative Investment Fund Managers Act (the *"AIFM Act"*), which implements the European Union's AIFM Directive (the AIFMD). The AIFM Act governs authorisations and operations for alternative investment fund managers in Sweden, under the supervision of the Swedish Financial Supervisory Authority.

Exemptions apply under EU frameworks such as EuVECA and ELTIF. EuVECA allows eligible managers to market venture capital funds targeting early-stage SMEs across the EU, while ELTIF supports long-term investments in infrastructure and sustainable projects within the EU, accessible to both professional and retail investors within the EU.

2.4 Particularities

Sweden is recognised as the Nordic region's most active and mature venture capital ecosystem, with a strong tech focus. The Swedish VC fund environment remains dynamic and continues to evolve in response to both local innovation and global investment trends.

Reflecting Sweden's broader ESG focus and strong innovative culture, Sweden has several dedicated impact funds such as:

- Norrsken VC – Europe's largest early-stage generalist impact fund and early investor in Northvolt and Einride, which targets companies addressing societal challenges through technology;
- Industrifonden – a government-controlled Nordic evergreen fund with USD600 million in assets under management, which backs early-stage technology and life science companies with international potential;
- Summa Equity – investing in start-ups aligned with the UN Sustainable Development Goals;
- Vargas Holding – is not a traditional VC fund but a long-term greenfield impact investor that identifies, validates, finances, launches and scales impact companies from scratch, including Stegra, Polarium, Northvolt and Aira, focusing on high-impact sectors such as clean energy, mobility and sustainable material; and
- Impact Invest and Trill Impact – employ a private equity strategy to achieve significant and measurable impacts while also delivering financial returns.

Sweden also maintains a long-standing tradition of government involvement in venture capital with government-controlled funds such as:

- Almi Invest – which is recognised as one of Sweden's most active early-stage investors;
- Industrifonden – which operates as a foundation that invests in Swedish companies with international growth potential and focuses on advanced technologies addressing significant societal challenges;
- Saminvest – which serves as a fund-of-funds investor aimed at stimulating the private venture capital market;
- Energimyndigheten Holding AB – the Swedish Energy Agency's investment company, which collaborates with InnoEnergy to invest in innovations relating to energy.

These government-controlled funds have played a crucial counter-cyclical role, particularly during periods of global downturn or tightening capital markets.

With the exception of Saminvest and Swedish Venture Initiative, there are very few fund-of-funds on the Swedish VC market.

There is growing discussion around continuation funds and other secondary structures within the VC market in Sweden, particularly among more mature VC funds seeking liquidity for older assets and in light of extended exit horizons in certain verticals such as deep tech and life science. While continuation funds are still very uncommon in the Swedish VC market, such structures have been observed among later-stage growth and PE funds. Furthermore, evergreen funds (which typically, unlike other funds, do not have a fixed investment period and/or end date) are also growing increasingly common on the Swedish market. During 2024, Northern Horizon launched its first evergreen fund with a specialised focus on social infrastructure. Also, as mentioned above, Industrifonden has an evergreen structure in place in order to be able to focus on long-term value creation rather than short-term returns. Evergreen funds are, however, still more common on the private equity side, noting in particular that EQT communicated that it intends to expand its offering with an aim to have up to five active evergreen funds within the coming year.

3. Investments in Venture Capital Portfolio Companies

3.1 Due Diligence

The level of due diligence conducted by VC fund investors in Sweden varies, mostly depending on the relevant investment round, valuation and size of investment as well as the particular industry of the target and the relevant legal risks. The due diligence is also tailored based on issues that are specific for the fund, including ESG if the fund has adhered to the SFDR framework.

For investment in early-stage start-ups, the legal due diligence can be rather limited, with the investor's main focus being on the commercial/financial aspects and the business plan. In later-stage VC investments and growth, the due diligence is generally more robust and in line with what one would expect in an M&A transaction.

Typical key areas of focus for VC fund investors in Sweden are:

- title and ownership – capitalisation table, dilutive instruments and any incentive schemes;
- employment terms – founders and key employees' employment agreements, verification of existence of non-compete/non-solicitation clauses, confidentiality clauses and sufficient assignment of intellectual property rights;
- IP/ownership of technology – ownership and robustness of IP needed to run the business, particularly if third-party consultants have been engaged in development;
- material agreements – critical agreements that underpin the business model and operations;
- regulatory – assessing regulatory requirements or approvals, including whether the target's business is subject to the FDI Act (which, if applicable, will prolong the time necessary between signing and closing of an investment); and
- disputes – ensuring no major ongoing disputes.

3.2 Process

In Sweden, the timeline of a new financing round in a growth company with a new lead investor can vary, and the trend over the last year

is that it has expanded somewhat. In 2025, the expected timeline is typically between four and eight weeks, subject to regulatory approvals and investors' requirements. If a term sheet is agreed upon, which is typically the case, the timeline can be shorter.

In new financing rounds in growth companies, the lead investor typically takes an active role and has its own legal counsel. Other larger new investors may engage separate counsel, depending on size of investment and alignment of interest, while smaller investors tend to follow the terms negotiated by the lead investor, without engaging own counsel. The company will have its own counsel. Whether founders and existing investors have the same counsel or not largely depends on how aligned their interests are in the new round. The target is often required to cover reasonable legal fees of the lead investor, subject to a cap.

A new financing round in growth companies will typically require amendments to or deviations from the shareholders' agreement to which all existing shareholders are parties. Consequently, the existing shareholders need to agree to amend (or replace) the shareholders' agreement in order to complete the new round, which typically requires that all shareholders agree. Swedish law-governed shareholders' agreements sometimes contain provisions such as that 90% of the shareholders can amend the agreement or power of attorneys, but they are seldom relied on in practice due to enforcement and revokement risks under Swedish law.

3.3 Investment Structure

In Swedish start-ups, *"ordinary shares"* (as they are more commonly referred to in Sweden) are typically held by founders, key employees and potentially a few very-early-stage investors. Ordinary shares have voting rights (all shares in Swedish limited liability companies must have voting rights – ie, it is not possible to issue non-voting shares, and no share may carry voting rights that are more than ten times greater than the rights of any other shares), but they are typically last in the equity waterfall and last to be paid out in a liquidation event.

Later-stage VC investors, typically invest via preference shares that sit higher up in the equity waterfall and have rights that are more advantageous than ordinary shares, such as liquidation, anti-dilution and distribution preferences. The standard practice in Sweden is to issue non-participating preference shares with a 1x liquidation preference. However, during the last years, some founders and existing investors have been forced to agree to more aggressive liquidation terms due to fundraising challenges in the prevailing market to avoid down rounds.

3.4 Documentation

In Sweden, the typical key documents representing a financing round in a growth company include the following.

- Term sheet: Non-binding document outlining key terms of the investment round. Even if the term sheet is non-binding (save for with respect to *"no-shop"*, confidentiality and governing law), it is nonetheless typically strictly adhered to by Swedish VC investors and considered morally binding by the parties.
- Investment/subscription agreement: Binding agreement between the investors, the company and the founders/existing shareholders, setting out the number and classes of shares to be subscribed for, subscription price and representations and warranties provided to investors as well as any conditions to closing and actions at closing.

- Shareholders' agreement: Binding agreement between the shareholders and sometimes, even if uncommon in Swedish governed agreements, the company, governing the relationship between them. Key provisions include:
  (a) governance and investor protection rights, including board nomination rights, reserved matters and information rights;
  (b) participation rights, such as pre-emptive rights for new financing rounds (usually with exceptions for incentive programmes, distress issues and M&A activities undertaken by the company);
  (c) transfer restrictions, including right of first refusal, drag-along, and tag-along rights (with exemptions for *"permitted transfers"*)
  (d) founder vesting and lock-in arrangements (not standard);
  (e) anti-dilution and down-round protection (not standard);
  (f) liquidation preferences;
  (g) exit provisions; and
  (h) non-compete and non-solicitation provisions.
- Articles of association: The company's constitutional document, which is rather standardised and sets out, inter alia, the share capital, number of shares and any share classes with related rights – eg, liquidation and distribution preferences and voting rights (maximum 1:10) and restrictions on the transfer of shares (which are limited to consent clause, right-of-first-refusal and post-sale purchase right).

In addition to the above, certain corporate documents are also required, such as minutes from the shareholders' meeting (or board meeting) resolving on the new issue of shares.

There are no frequently used templates in the Swedish VC market (such as – eg, the NVCA or the BVCA template documentation). However, the market practice is harmonised and negotiations are usually efficiently conducted between reasonable parties (provided that all parties and counsels are accustomed to Swedish venture capital investments).

3.5 Investor Safeguards

In Sweden, the most common investor safeguard mechanisms that VC investors typically are able to secure vis-à-vis other investors/founders and employees are the following.

- Pre-emption rights and subscription rights: All shareholders typically have a pre-emption right to subscribe in new financing rounds in proportion to their existing shareholdings in order to preserve their ownership level. Common exceptions include share issuances under agreed incentive programmes, during financially distressed situations and in conjunction with M&A undertaken by the company.
- Liquidation preference/exit preference: Investors typically hold preference shares, which entitles them to a liquidation preference ensuring that the VC investors at least get their investment amount back (either with or without a multiple) before any ordinary shares receive any exit or liquidation proceeds. It varies as to whether the VC investor also has the right to participate pro rata in any remaining proceeds along with the ordinary shareholders (a so-called participating liquidation preference). The standard practice in Sweden is to issue non-participating preference shares with a 1x liquidation preference. In distressed situations, VC investors are sometimes able to get a higher liquidation multiple

and/or participation on their liquidation preference.
- Reserved matters/veto rights: Investors typically negotiate *"reserved matters"* catalogue, which reinforces investor protections. Such provisions typically restrict the issuance of securities that rank senior to those held by the investors and/or alter the rights of already issued securities.
- Anti-dilution rights: These are becoming more common in Swedish venture capital investments and typically they are in the form of a weighted average ratchet. Full ratchet anti-dilution provisions are uncommon in the Swedish market.

3.6 Corporate Governance

In Sweden, a VC investor would typically exercise its influence through its voting rights as a shareholder in the company and is typically able to secure the following rights to influence over management/the affairs of the venture in a shareholders' agreement.

- Board representation: The lead and other larger investors often get the right to appoint one or more representatives to the company's board. In case they do not want to appoint a board member – eg, in order to not be exposed to the fiduciary obligations that come with being a board member, the lead and other larger investors instead get the right to appoint a board observer without voting rights.
- Reserved matters/veto rights: Investors are typically granted influence over certain significant decisions through *"reserved matters"* catalogue. The nature of such influence – whether as veto rights for certain specific investors or as voting rights for a group of investors/shareholders – depends on the overall shareholding structure as well as the relevant company's negotiating position. The reserved matters typically include the following:
  (a) amendment of the articles of association;
  (b) decisions that would dilute the investors' shareholding, such as changes to share capital and the issuance of securities;
  (c) approval of any dividend, distribution, or return of capital to shareholders;
  (d) changes in the company's strategic direction, certain operational resolutions such as budgets, business plan, raising loans and initiating litigation above a certain threshold;
  (e) consent to voluntary liquidation, dissolution, winding-up, bankruptcy, reconstruction or reorganisation of the company; and
  (f) related-party transactions.
- Information and audit rights: investors typically enjoy information and/or audit rights, which allow them to access certain information regarding the company's operations and financials as well as oversee their investments.

3.7 Contractual Protection

Representations and Warranties

In Sweden, the representations and warranties commonly observed in a financing round in a Swedish start-up or growth company are the following:

- power and authority;
- ownership of the issued shares;
- corporate matters;
- financial information;
- material agreements;
- related-party transactions;
- real property and other assets;
- IPR and IT;
- data privacy and GDPR;

- employees and pensions;
- tax;
- compliance, permits, etc;
- sanctions and anti-money laundering (AML);
- litigation; and
- disclosed information.

The level of negotiation and extent of the reps and warranties differs depending on the target company, its industry and its stage of development, with more extensive warranties often seen in later-stage funding rounds. A Swedish representations and warranty catalogue is typically less extensive than what is seen in the US. Further, disclosure letters are not common in Swedish VC investments.

Forms of Recourse

With regards to recourse, it is typically the founders and all or some of the other existing shareholders, depending on the situation, that give the representations and warranties to the investor in the investment agreement, severally and not jointly and on a pro rata basis. If and to what extent the company itself can provide, and be held liable for warranties, is subject to legal debate in Sweden. The prevailing view is that a company cannot be held liable to its investors (ie, in their capacity as subscribers of shares in the company) in connection with a new issue of shares, as the protection of the company's creditors is prioritised over that of its investors. However, it is common that the investment agreements are drafted so that the company also stands behind the warranties (sometimes with the caveat, to the extent legally permissible) and that any claim will be compensated by the issuance of new shares at quota value (compensation shares), in which case all shareholders must have agreed to such issuance of shares (given that the arrangement dilutes the other shareholders in benefit of the indemnified investor). It is also not uncommon in Swedish investment agreements that existing shareholders are allowed to indemnify a claim by transfer of existing shares or a combination of cash and existing shares (due to the fact that the founders or other existing shareholders may not have the liquidity to satisfy a claim in cash, as the investment is received by the company).

Liability for warranty breaches is usually limited by both time restrictions and monetary caps. Further, in Swedish-style transactions, it is common practice that the warrantors are exempt from liability concerning issues that were (fairly) disclosed during the due diligence process, irrespective of whether the investor had actual knowledge of those issues.

Covenants and Undertakings

The investment agreement will include inter alia investor safeguarding covenants regarding the operation of the company's business between signing and closing (which is to be conducted in its ordinary course of business), steps to be taken at closing by the company and existing shareholders (eg, undertakings to ensure valid issuance of the new shares) and condition precedents such as FDI approval(s) as well as consents from counterparties in relation to any change-of-control clauses (in each case if required)).

Further, the investor is safeguarded through restrictive covenants in the shareholders' agreement (such as non-compete and non-solicit, as well as customary confidentiality clauses).

4. Government Inducements

4.1 Subsidy Programmes

Various government programmes offer grants or subsidies to support innovative projects within growth companies. These programmes often encourage research and development, helping companies to develop new products or technologies that can attract private investment. Further, low-interest loans or guarantees are available to start-ups and growth companies, aiming to ease financial pressures and facilitate expansion. These loans can supplement equity financing, allowing companies to leverage additional capital for growth initiatives. These programmes collectively create a conducive environment for growth companies, making it easier for them to secure the necessary capital for expansion and innovation.

One relevant example is the state aid received by Stegra (previously H2 Green Steel) amounting to approximately EUR105 million, during 2024, from the Swedish Energy Agency (*Energimyndigheten*). However, following the media storm after Northvolt's bankruptcy, the state aids granted on the Swedish market have been questioned and the Swedish government has since then decided to deny Stegra further funding (even though it had been approved by the EU).

4.2 Tax Treatment

The tax rules set out below apply to all Swedish limited liability companies (*aktiebolag*) and are not specific to VC investments.

Capital contributed to a Swedish limited liability company – whether through share issues, shareholder contributions, or loans – does not generally constitute taxable income or a VAT liable transaction.

For Swedish corporate investors, income (including interest) is subject to taxation at the statutory corporate income tax rate of 20.6% (2025), unless an exemption applies. However, Sweden offers a favourable tax regime for Swedish corporate investors through the participation exemption regime (*näringsbetingade andelar*). Under this regime, dividends and capital gains realised by a Swedish limited liability company on shares held as capital assets, are generally tax exempt, provided that the shares are unlisted.

An investment into a Swedish limited liability company by foreign investors does generally not give rise to a Swedish permanent establishment or a liability to file income tax returns in Sweden. Foreign investors without a Swedish permanent establishment are not subject to taxation on capital gains on shares and other instruments in Swedish limited liability companies.

Sweden does not levy withholding tax on repayment of principal and interest on loans paid to foreign lenders. Dividends paid on shares in Swedish limited liability companies to foreign shareholders without a Swedish permanent establishment are, as a general rule, subject to withholding tax at 30%, unless an exemption applies or if the tax rate is reduced under an applicable tax treaty (in certain cases to 0%). It can be noted that repayment of conditional shareholder contributions is for tax purposes considered as a repayment of debt and therefore not subject to withholding tax.

4.3 Government Endorsement

By way of government-controlled funds, the Swedish state maintains its role as an active investor in the Swedish venture capital landscape, providing both equity and debt financing to various investees. As outlined in **2.4 Par-**

ticularities, these funds have played a crucial counter-cyclical role, particularly during periods of global downturn or tightening capital markets.

Furthermore, to address the asymmetric tax treatment of equity and debt – where returns on equity are subject to double taxation, while interest on debt is taxed solely at the level of the lender – Sweden implemented general interest deduction limitation rules effective as from 1 January 2019. Under these rules, companies may deduct net interest expenses up to 30% of their EBITDA or, alternatively, up to SEK5 million on a Swedish group level under a de-minimis rule.

5. Employment Incentives

5.1 General

In Sweden, the long-term commitment of founders and other key employees is typically secured through a combination of equity-based incentive structures and contractual mechanisms. These typically include the following elements.

- Equity-based incentive schemes: It is market standard for founders and key employees to be offered equity incentives – either through direct share ownership or participation in incentive programmes (such as options or warrants) – in order to align their interests with the long-term value creation of the company.
- Vesting and lock-in provisions: Vesting and lock-in provisions are widely used for founders and key employees in early-stage financings, particularly where founders retain significant ownership stakes. Such provisions typically make continued equity ownership conditional on ongoing engagement with the company over a defined period.
- Leaver provisions: Swedish venture capital transactions regularly include leaver provisions, distinguishing between *"good leavers"* and *"bad leavers"*, with differing consequences in terms of equity retention or forfeiture. Participation in equity programmes is typically contingent upon continued employment or consultancy engagement, although the scope and duration of such conditions may be limited due to applicable Swedish tax rules.
- Transfer restrictions: To maintain ownership stability and ensure alignment among key stakeholders, share transfer restrictions are commonly imposed on founders and key employees. These may include contractual lock-ups, rights of first refusal, and tag-/drag-along rights, typically set out in the shareholders' agreement to ensure that founders and key employees remain invested in the company.
- Restrictive covenants: Non-compete provisions are routinely included in both the shareholders' agreement and the individual employment contracts. Under Swedish employment case law, non-compete provisions in the employment contract are subject to specific statutory limitations, including requirements for post-termination compensation. By including such restrictions in the shareholders' agreement, the company and its investors is provided an additional layer of protection against competitive activity by founders and key individuals, beyond the confines of employment law.

5.2 Securities

In Sweden, both equity and equity-based instruments are used for purposes of incentivising founders and employees as well as aligning the interests of founders and employees with the company's long-term success. The choice of instrument often depends on the stage of the

company, tax considerations, and the participants (eg, founders or employees). The most typical instruments include the following.

- Warrants (*teckningsoptioner*): Securities that are registered with the Swedish Companies Registration Office, giving holders the right to subscribe for new shares in the company at a later stage without requiring a new share issue at the time of exercise.
- Share options: Similar to a warrant, but a more flexible instrument which is based on contractual rights (call or put option) entered into with existing shareholders, allowing the holder to acquire or sell already issued shares under predefined terms.
- Synthetic options: Cash-settled instruments where the holder receives a payment, reflecting the value development of a share during a predetermined period, without granting any equity.
- Employee stock options (*personaloptioner*): The employee stock option itself is not a security, however, it entitles the holder to purchase equity or equity-based instruments in the future at a predetermined price or otherwise on favourable terms, generally subject to continued employment and/or other conditions.
- Qualified employee stock options (*kvalificerade personaloptioner*): Participants are granted an employee stock option, exercisable no earlier than three years and no later than ten years after grant of the option, and which meet certain other specific conditions, entailing that the employee will not be taxed on benefits when the qualified employee stock option is exercised. The purpose of the rules is to enable small, start-up and innovative companies with limited resources to recruit and retain key talent and thereby be able to grow by ensuring taxation is made as income of capital.

5.3 Taxation of Instruments

When determining the structure of an incentive pool in a Swedish company, certain tax considerations are key, particularly with respect to the timing of taxation and applicable tax rates.

Equity-based instruments, such as shares and warrants, are generally treated as securities for Swedish tax purposes, provided that they are not subject to far-reaching restrictions (eg, non-transferability or forfeiture upon termination of employment which are not limited in time). If they are, there is a risk that the equity instrument is instead taxed as an employee stock option or deemed to have been acquired when the restrictions lapse (typically upon disposal).

If a security is acquired below fair market value, the difference between the acquisition price and the market value is taxed as employment income at progressive tax rates up to approximately 52% at the time of acquisition. Additionally, the employer is generally liable for employer social security contributions on the benefit at a rate of 31.42% (uncapped). A subsequent increase in value is typically taxed as capital income at a flat rate of 25% for unlisted shares or otherwise 30% for an individual (unless the closely held company rules apply), and at 20.6% for a corporate investor if not tax exempt under the Swedish participation exemption regime (please refer to **4.2 Tax Treatment**).

Benefits from employee stock options are normally subject to employment taxation and social security contributions when exercised (ie, when the employee acquires the underlying shares). However, under the special rules for qualified employee stock options, no taxation arises for

the employee at the time of exercise, and the employer is not subject to social security contributions, provided that certain conditions are met. A later increase in value is typically taxed as capital income as described above.

Cash-based awards and return from phantom schemes are generally taxed as employment income when paid.

5.4 Implementation

The implementation of an investment round and the setup of an employee incentive programme (ESOP) are closely related in terms of process and dilution. The relationship between investment rounds and employee incentive programmes is strategic, requiring considerations in relation to the size, structure, and timing to mitigate dilution while effectively retaining talent.

Establishing an ESOP pool leads to dilution for existing shareholders, which must be factored into the overall equity structure and valuation discussions during the investment round. Investors may seek to adjust the ESOP pool size based on negotiated terms, influencing equity distribution among shareholders. Hence, the size of the ESOP pool is usually discussed and agreed upon early in the process, whereas the actual implementation is usually carried out separately from the investment round to avoid complicating the closing process of the investment.

6. Exits

6.1 Investor Exit Rights

In the context of Swedish corporate governance, a shareholders' agreement often includes a variety of exit-related provisions to safeguard the investors' interests. These provisions usually aim to regulate the transfer of shares and facilitate exits. Certain provisions of the shareholders' agreement are backed up by corresponding transfer restrictions in the articles of association, by the inclusion of a post-sale purchase rights clause, in order to prevent share transfers that violate the shareholders' agreement. As an example, you will usually find the following provisions.

- Exit initiation: Investors typically possess specific rights related to formal exit proceedings. These rights often include the ability to initiate an exit through an IPO or a trade sale (usually connected to a specific time having passed since the investment), in order to ensure that the investors can manage their divestment and avoid lock-in effects by ensuring an effective way to liquidate their position. When initiating such exit, investors have the authority to appoint an adviser, such as an investment bank, to facilitate the exit process.
- Right of first refusal: The right of first refusal provision enables the existing shareholders to acquire shares with a priority right prior to such shares being transferred to a third-party acquirer, at the same price and terms offered by the prospective purchaser. It is common for the right of first refusal to apply on a pro rata basis amongst existing investors, and it usually also includes a secondary right for shareholders to acquire shares in the event that any of the existing shareholders decide not to exercise their primary right of first refusal.
- Tag-along rights: In the event of a sale of shares to a third-party acquirer and provided that not all such shares are acquired by existing shareholders pursuant to the right of first refusal, shareholders will typically have a right to tag-along on such sale under the same terms and conditions on a pro rata basis. The tag-along right may apply from the first share,

but it is also common for it to be contingent upon a specific threshold being met – eg, 10% of shares in a single transaction or multiple transactions being effectuated to the same transferee. In essence, the tag-along acts as a protection for minority shareholders which may otherwise have difficulties exiting a portfolio company in case the majority decides to liquidate its positions and transfer its ownership to a third-party acquirer.

- Drag-along rights: These rights are intended to allow for a specified majority of shareholders to force minority shareholders to sell their shares in the event of – eg, a trade sale, ensuring that the transaction can proceed without minority holdout issues. One key point to remember is to include an authority for a representative of the dragging majority to represent the dragged parties during the sales process to further avoid any unnecessary hiccups during the sales process. The drag-along provision will typically require a qualified majority in order to be applicable, and such constellation can take many different forms, from including both a majority of ordinary shares and preference shares to specific veto rights for a certain class of share and/or investors.

While the authors have not seen any wholesale shift in exit-related rights, the slowdown in liquidity events is reshaping expectations and bringing more investor-friendly exit mechanisms into play, especially in later-stage rounds. There are also discussions around continuation funds and other structured secondary structures on the VC market in Sweden, particularly in light of extended exit horizons in certain verticals such as deep tech and life science, as well as insufficient IPO liquidity available.

6.2 IPO Exits

During the hay days of 2021 and 2022, several IPO exits of start-ups took place in Sweden, including the IPOs of Polestar, Oatly and Truecaller. However, the Swedish IPO market has been relatively slow since then, leading to fewer IPOs in general. Although there has been an increase of notable IPOs of venture capital-backed companies more recently (such as Yubico's de-SPAC listing in 2023 and subsequent uplisting to the main market at Nasdaq Stockholm in 2024, and the IPO of Cinclus Pharma), the IPO exit route remains challenging with insufficient IPO liquidity available. Despite the slow IPO market there is optimism for an upturn in IPO activity during 2025 and 2026, which should also enable IPO exits for start-ups.

There are multiple listing venues in the Swedish market, the most prominent of which are the regulated marketplace of Nasdaq Stockholm, being primary exchange for larger and more mature companies, and the MTFs Nasdaq First North Growth Market as well as NGM Nordic MTF, being a less regulated and more flexible trading venue suitable for smaller companies with high-growth potential. It is common that start-ups typically list on an MTF and make an uplift to the main market after a period of time.

Historically, start-ups typically have pursued offering structures consisting of a combination of existing shares (secondary offering) and new shares (primary offering). However, during 2023 we also saw the IT-security company Yubico's IPO via a de-SPAC, which is quite unusual in the Swedish market.

6.3 Pre-IPO Liquidity

The market for secondary shares in Sweden is generally very active with both Swedish and foreign investors acquiring shares in sought-after

companies which may otherwise be difficult to subscribe for via typical fundraising rounds. This enables both investors and employees to liquidate their positions prior to the shares being publicly traded and is also used to clean up the cap table pre-IPO. Firms like Klarna, Northvolt, and Spotify (pre-IPO) have all seen structured secondary transactions. Today, it is quite common for growth-stage Swedish companies (particularly in fintech, deep tech or SaaS) to facilitate these deals.

7. Regulation

7.1 Securities Offerings

In Sweden, the offering of equity securities by a private, non-listed company, is not subject to any specific securities regulations under Swedish law. However, private limited liability companies (*privata aktiebolag*) are subject to restrictions on how they can market and distribute their shares. In particular, they are not permitted to make public offerings and cannot extend an offer to more than 200 individuals. In the event that a company intends to raise capital to a wider range of public investors, the company must, prior to doing so, be converted into a public limited liability company (*publikt aktiebolag*) which – while distinct from being listed on a regulated market or a multilateral trading facility – allows for a broader issuance of shares.

The EU Prospectus Regulation (Regulation (EU) 2017/1129) applies to public limited liability companies, which sets out the conditions under which a prospectus must be prepared. In general, if an offering is directed to the general public (being defined as more than 149 individuals), a prospectus may be required, unless an exemption applies.

In venture capital transactions, these provisions become particularly relevant in larger financing rounds or in cases where numerous employees or other stakeholders hold equity instruments. Companies planning for expansion or broad-based equity offerings must carefully consider these legal requirements to ensure compliance and avoid unintended regulatory consequences.

7.2 Restrictions

While banking-related regulations may apply when investing in fintech and other companies under supervision by the Swedish Financial Supervisory Authority (eg, in relation to ownership assessment), Sweden has traditionally maintained an open investment environment with no general restrictions on FDI in Swedish companies. However, in December 2023, Sweden implemented the Foreign Direct Investment Act (the *"FDI Act"*) with an overarching goal to preserve and protect Swedish interests.

The implementation of the FDI Act has significantly altered the regulatory landscape for not only foreign investors, but national investors as well, as the FDI Act dictates that all transactions (including intra-group reorganisations) which are within the scope of the act must be notified to the regulators. The FDI Act establishes a mandatory screening mechanism for certain foreign investments, particularly those involving businesses engaged in activities deemed critical to national security, public order or essential societal functions. The scope of the act is broad and covers investments in sectors such as defence, energy, telecommunications and other strategically important industries. Depending on the nature of the target company's operations, foreign and national venture capital investors may be subject to notification requirements and regulatory review, which could delay or, in rare cases, restrict an investment.

In order for the FDI Act to be applicable, the following conditions must be met:

- the investee entity or any of its subsidiaries must be incorporated in Sweden; and
- the transaction, irrespective of form (eg, green field investments, new share issues and acquisition of shares) must result in the investor:
  - (a) acquiring at least 10% of the votes in the company (or increasing its existing stake to 20%, 30%, 50%, 65% or 90%); or
  - (b) gaining influence over the investee – eg, by way of the right to appoint a board member or the right to influence the overall business of the investee.

Once it has been determined that the FDI Act applies, the process will, on a high-level, look as follows: a complete notification is filed with the Inspectorate of Strategic Products (ISP), after which an initial assessment (phase 1) is carried out by the ISP pursuant to which it has 25 business days to determine if an enhanced review (phase 2) is required. If the ISP deems that *"phase 2"* review is required, such review can take up to three months to complete, extended by an additional three months if deemed necessary by the ISP. During the duration of the review period there is a standstill obligation until the ISP explicitly issues a no action letter or an approval (ie, no implicit approval when the statutory deadline lapses). It should furthermore be pointed out that a transaction not subject to a mandatory filing obligation may nevertheless be *"called-in"* at the discretion of the ISP.

During the period from 1 December 2023 until November 2024 (ie, the first year after the implementation of the FDI Act), the ISP received 1,206 notifications for which an enhanced review was initiated in 24 cases, out of which 11 investments were approved without any conditions and five approved with conditions. The large number of transactions having been notified to the ISP is likely a result of the risk of hefty fines and transactions being considered null and void in case of non-compliance with the FDI Act, together with certain difficulties in determining whether a transaction is in fact notifiable under the Act, given its broad scope and a lack of clear guiding precedents from the ISP.

Trends and Developments

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Gernandt & Danielsson Advokatbyrå KB has an established reputation as one of the leading law firms in Sweden. The firm has approximately 100 lawyers in Stockholm and has a strong international practice. It provides advice to both Swedish and international clients. The firm regularly works on cross-border transactions and has close working relationships with leading law firms in all Scandinavian jurisdictions, elsewhere in Europe, the UK and around the world. Gernandt & Danielsson advises both investors and venture capital-backed companies in all types of venture capital matters, including equity investments, growth financing, fund formation, joint ventures and exit processes such as trade sales and IPOs as well as advising management of portfolio companies. The team includes a strong bench of leading individuals, specialised in various areas such as M&A, capital markets, private equity, venture capital, fintech, regulatory, artificial intelligence, employment and GDPR.

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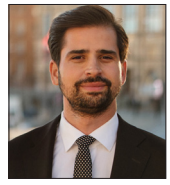

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Introduction

Sweden, long recognised as the Nordic region's most active and mature venture capital ecosystem, is home to more than 4,700 venture capital funded start-ups which raised over EUR2.4 billion in VC investments in 2024 (according to dealroom.co). Sweden is also the birthplace of more than 40 unicorns, including Skype, Klarna, Spotify and iZettle. The Swedish ecosystem also benefits from a snowball effect as former founders and employees of successful unicorns have founded multiple new start-ups such as Neko Health, a preventative healthcare technology company, co-founded by Daniel Ek (Spotify). Klarna co-founder Niklas Adalberth, is the co-founder of Norrsken VC, which is currently the largest early-stage generalist impact fund in Europe.

As a cornerstone of the Nordic economy and a nation celebrated for its entrepreneurial spirit, Sweden's business environment is distinguished by its political stability, vigorous legal framework, and unwavering commitment to sustainability and innovation. These elements, along with Sweden's thriving tech sector, a rapidly growing health tech industry, and an upcoming clean tech and deep tech industry, position the country as a prominent hub for venture capital activity.

In recent years, there has been a significant surge in investment directed towards start-ups that prioritise sustainability and digital transformation in Sweden, mirroring global trends that emphasise environmental responsibility and technological advancement. Looking forward, investors can expect a promising pipeline of opportunities in the Swedish market, notably in impact sectors such as technology (in particular clean tech), renewable energy and health innovation, while at the same time being tasked with navigating an evolving Swedish (and European) regulatory landscape. This landscape includes the new Swedish foreign direct investment (FDI) screening process that was implemented in December 2023 and compliance with various EU regulations, such as CSDR and DORA.

The Swedish Venture Capital Market

The Swedish venture capital market is a vibrant ecosystem. The market comprises several key players that drive innovation and support start-ups, including public investors, incubators, angel investors and, of course, the venture capital funds.

Public investors

Public investors, including government agencies like Almi Invest, which is Sweden's most active start-up investor, and Vinnova, which is an innovation agency with a mission to strengthen Sweden's innovative capacity and contribute to sustainable growth, play a vital role in the Swedish VC landscape. They provide funding and foster a supportive environment, enhancing the attractiveness of the market for start-ups. The Swedish government (eg, through the Swedish Agency for Economic and Regional Growth (*Tillväxtverket*) and the Swedish Energy Agency (*Energimyndigheten*)) has regularly provided companies with large amounts of state aid (the most recent examples being Northvolt and Stegra (formerly H2 Green Steel)). The Swedish state also maintains its role as an active investor in the Swedish venture capital landscape by providing both equity and debt financing to various investees, through government-controlled funds, such as Industrifonden, which backs early-stage technology and life science companies with international potential.

Incubators

Incubators are essential in nurturing early-stage start-ups by offering mentorship, resources

and access to networks (including angel investors and venture capital funds). Sweden has a world-class innovation support system and several prominent incubators, such as Stockholm Innovation & Growth (STING) and Uppsala Innovation Centre, which have successfully supported numerous start-ups in their early stages. This ecosystem plays a pivotal role in fostering technological advancements, collaboration between academia and industry, and contributes significantly to the growth of the Swedish venture capital market.

Angel investors

Angel investors are vital in the Swedish venture capital landscape, providing early-stage funding and support to start-ups. Networks like the Swedish Business Angels Network (SBAN) connect start-ups with high net worth individuals who offer both capital and valuable expertise. The community of angel investors plays a crucial role in bridging the funding gap for start-ups that may not yet be ready for venture capital investments.

Venture capital funds

Venture capital funds are the backbone of the Swedish venture capital market, providing significant capital to start-ups. The Swedish funds vary in size and focus, with some specialising in specific sectors and others being generalist impact funds. Notable VC funds in Sweden, such as EQT Ventures, Northzone and Creandum, have been early investors and made substantial investments in successful start-ups, contributing to the vibrant Swedish start-up ecosystem.

Sweden is also the home of several impact funds, which are targeted towards generating a positive environmental and/or social impact, while at the same time generating a financial return on its investments. This aligns well with Sweden's broader ESG focus and aims towards a sustainable and viable future. Such funds include Norrsken VC, the largest early-stage generalist impact fund in Europe, Industrifonden, which focuses on early-stage technology and life science companies with international potential, and Summa Equity, investing in start-ups aligned with the UN Sustainable Development Goals.

Venture Capital Market Trends

Sweden, long recognised as the Nordic region's most active venture capital ecosystem, experienced a cautious start in 2024 and a decline in funding by 41.7 % compared to 2023. Deal activity remained significantly below record levels seen in 2021–2022 (according to PitchBook data). However, signs of stabilisation and resurgence began to emerge in the second half of 2024 and have been continuing into 2025. Key sectors such as technology (in particular clean tech), renewable energy and financial services have led this revival, fuelled by resilient fundamentals and a renewed sense of confidence among investors. There has been a clear trend among investors favouring early-stage companies that are less capital-intensive and require fewer capital injections, particularly in sectors like fintech and software as a service (Saas). However, despite the significant capital needs typically associated with deep tech companies before they reach the commercial phase and generate meaningful revenue, there was an increase in both the number and size of investments in this segment during 2024.

As we transition into 2025, a vibrant start-up ecosystem, sustained interest from international investors, and an uptick in defence spending are creating opportunities for the venture capital landscape in Sweden. Despite challenges from ongoing global trade tensions and currency fluctuations, Sweden's open and export-oriented

economy positions it as a strategic location for foreign investors seeking to establish a foothold in Europe.

Thriving start-up ecosystem

Sweden's start-up ecosystem is a major driver of this momentum. Stockholm, often dubbed the *"unicorn factory"*, has cultivated a robust environment for high-value start-ups, consistently attracting attention from both private equity and venture capital firms. Along with other Swedish innovation hubs like Gothenburg and Malmö, it is home to a diverse array of tech-driven ventures that are making waves not only in Europe but globally too.

Sweden is known as one of the world's most innovative countries, consistently being placed high in international rankings year after year. Notably, the technology sector continues to dominate venture capital investments, with areas such as clean tech, fintech, health tech and software development witnessing remarkable growth.

Key market trends and industries

In 2024, sustainability remained a dominant focus in venture capital investments. As companies strive to meet stricter environmental targets and regulations as well as consumer demand for sustainable products, investors tend to prioritise start-ups that offer innovative solutions in clean technology and sustainable business models. This collective commitment to sustainability is spurring venture capital activity in areas such as wind energy, battery storage, hydrogen projects and other green technologies. However, traditional sectors such as fintech and SaaS have remained the leading drivers of Swedish venture capital investments.

The ongoing digital transformation across various industries is expected to continue to create opportunities for venture capital investment in Sweden. Start-ups that leverage digital tools and technologies to improve efficiency, enhance customer experience, or increase accessibility will be particularly appealing to investors. Another trend within Sweden's venture capital landscape, and globally, is the rapid growth of artificial intelligence (AI), where we have witnessed the rise of several promising start-ups focusing on AI, such as Sana Labs that provides an AI-powered learning solution, and Legora (formerly known as Leya) providing an AI-driven platform designed to enhance legal research and workflow automation. It is to be noted that Sweden is not as advanced in AI as other countries, such as the US or France.

Furthermore, the health tech sector, having gained momentum during the pandemic, is expected to continue its growth trajectory in 2025. Start-ups providing telehealth services, health monitoring technologies and personalised medicine solutions are expected to be in high demand, especially as healthcare systems adapt to new ways of delivering care.

Sweden's 2023 accession to NATO has ushered in a new era of defence co-operation and a heightened commitment to defence spending. The military budget proposal presented in October 2024 indicates a substantial increase in defence spending, projected to reach approximately 2.4% of Sweden's GDP by 2025. This, together with increased geopolitical tension leading to a growing demand for innovations with military applicability and Sweden's long-standing expertise in defence manufacturing, is expected to pave the way for new start-ups focusing on defence tech and dual-use solutions; those with both civilian and defence appli-

cations. While this segment is not expected to become a primary driver of Swedish VC activity in the near future, a growing number of Swedish dual-use start-ups have begun attracting early-stage capital as the national focus on defence tech is gaining momentum.

Exit opportunities and challenges

Exit activity remained subdued on the Swedish venture capital market in 2024, even though the general IPO market in Sweden somewhat recovered from previous years' all-time lows. A few exits and IPOs occurred in 2024 but nothing comparable to landmark exits in previous years. The exit environment continues to be difficult for venture capital backed companies with a slow M&A market and insufficient IPO liquidity available being the main challenges.

In recent years, Sweden has witnessed a notable outflow of its unicorns, with IPOs increasingly taking place on the US market rather than in Sweden. High-profile listings such as Spotify, Oatly, and Olink on Nasdaq US exemplify this trend. Notably, the anticipated IPO of Klarna, a prominent Swedish fintech company backed by venture capital, is also set to occur in the US market; however, as of the time of this article, it has been postponed due to market volatility and uncertainties surrounding valuation. This reflects a concerning trend for the Swedish IPO market, as companies appear to prefer going public in jurisdictions that offer the largest market size, as well as greater valuation potential and investor demand.

Profitability requirements and rise of bankruptcies

Despite the second half of 2024 and the start of 2025 presenting a more lucrative investment climate in Sweden compared to 2023, there are still several start-ups having had difficulties in raising sufficient capital. This is of course due to geopolitical and macroeconomic uncertainty but also as a result of investors shifting their investment appetite and focus; the previous mindset of *"growth at all costs"* is being replaced by profitability requirements and more strategic approaches. The LPs of venture capital funds are becoming increasingly more demanding, wanting to see returns on their investments rather than a hypothetical figure derived from the valuation in the latest investment round.

Starting in late 2023 and continuing into 2024 as well as 2025, there has been a rise in bankruptcies among Swedish start-ups. A recent major example is the bankruptcy of Northvolt, which underlines the many uncertainties facing capital-intensive industries. Once described as Europe's flagship manufacturer of batteries, Northvolt filed for bankruptcy in March 2025 despite having raised billions in funds and received substantial amounts of state aid.

Summary

In summary, as Sweden continues to foster a nurturing environment for start-ups and innovation, the venture capital landscape is set for sustained growth. With a strong emphasis on sustainability, digital transformation and strategic defence investments, together with an ever-growing appetite for AI-driven companies, Sweden is well positioned to attract a diverse range of venture capital investors in the coming years, paving the way for a dynamic and impactful investment ecosystem.

Regulatory Trends and Developments

Foreign direct investments (FDI)

The implementation of the new Swedish Foreign Direct Investment Act (the *"FDI Act"*) in December 2023 has significantly influenced the venture capital landscape in Sweden. The

FDI Act marks a notable shift in Sweden's historically open approach to foreign investments, introducing a new layer of scrutiny designed to protect national interests in the wave of geopolitical uncertainty. The FDI Act is broader than its equivalent in many other European countries and establishes a screening mechanism for investors acquiring (directly or indirectly) voting rights above certain thresholds (starting at 10%) or influence over Swedish-based companies preforming activities eligible for protection, particularly those involving businesses engaged in activities deemed critical to national security, public order or essential societal functions. The FDI Act targets all investors (Swedish, EU and non-EU) and does not have any turnover thresholds (however, certain thresholds are applied by the Inspectorate of Strategic Products (IPS) in order for a business to qualify as essential) and can also apply to intra-group reorganisations. However, only investors that are (directly or indirectly) non-EU will be subject to enhanced review and a decision to prohibit or impose conditions. As a result of the FDI Act, investors are required to navigate a more complex regulatory environment and structure investments more carefully.

During 2024, the ISP received 1,264 notifications out of which 1,107 were approved without an enhanced review being initiated. Out of the 26 notifications which were subject to enhanced review, 12 were approved, five were approved with conditions and one was prohibited. The large number of notified transactions is partly a result of investors taking a cautious approach as it has proven difficult to determine whether a transaction is in fact notifiable under the FDI Act or not, given its broad scope and a lack of clear guidance from the regulators. With time, investors and advisers have gained valuable insights into the screening processes, leading to improved predictability. This transparency is vital for making informed investment decisions and structuring transactions, including risk allocation and agreeing on what conditions, imposed by IPS, will be acceptable. Nonetheless, challenges such as potentially lengthy investment timelines persist, particularly for cross-border transactions that involve several jurisdictional with diversified regulations with different timelines.

Counter movement to increased regulatory landscape

With the Swedish (and European) business landscape becoming increasingly more regulated, there are emerging indicators of resistance to regulatory burdens and even signs of traction across various sectors as a result of various stakeholders pushing for a deregulation. This sentiment is fuelled from two fronts – firstly, by the EU's prioritisation of boosting industry competitiveness, and secondly, by national initiatives aimed at reducing the regulatory load on Swedish businesses. Consequently, policymakers are grappling with the challenge of balancing the need for effective regulation with the necessity of fostering an environment conducive to innovation and investment. It remains to be seen how the movement for deregulation will impact the venture capital environment in Sweden, but if successful, these efforts could lead to a more agile regulatory framework that empowers businesses while still ensuring accountability and ethical conduct, ultimately shaping the future landscape of investments in Sweden.

Taxation on carried interest

There is no current legislation or regulation of carried interest under Swedish tax law. Instead, taxation follows general tax rules and principles. Historically, carried interest received by Swedish individuals has been reported as capital income, subject to an effective tax rate of 25% or 30%.

However, since the Swedish Tax Agency (STA) initiated a review of the private equity sector in 2009, it has been the STA's opinion that carried interest should be regarded as a performance-based remuneration attributable to work carried out in the course of employment within the advisory company. As such, it should, in their opinion, be subject to taxation as income from employment for individuals (at progressive tax rates up to approximately 52%) and social security contributions at 31.42% payable by the employer. The STA does however acknowledge that there are situations where carried interest may be taxed under the rules on closely held companies (the so-called 3:12 rules), with taxation under the income categories of capital and employment but without being subject to social security contributions.

In August 2024, the Swedish government initiated a legislative process regarding the taxation of carried interest, which proposal was submitted on 28 January 2025. The purpose of this initiative was to assess how such taxation could be made more predictable and to propose provisions resulting in taxation comparable to that applied under the closely held company rules. In summary, the proposal suggests that the rules on closely held companies should generally apply to persons that, due to work or services, otherwise are entitled to carried interest in alternative investment funds (as defined under Swedish law), by expanding the definition of the term *"substantially active"* (*verksam i betydande omfattning*). Further, the proposal introduces specific provisions under the 3:12 rules applicable only to shareholders in companies entitled to carried interest. The new provisions are proposed to enter into force on 1 January 2026. In its consultation response (*remissvar*) regarding the proposal, the STA raised no objections to the implementation of the proposed provisions; however, they did indicate that certain provisions would benefit from further clarification.

Conclusion

The Swedish venture capital market is well positioned for significant growth, underpinned by a resilient economy, cutting-edge industries, and a strong commitment to sustainability and innovation. As we move into 2025, the start-up ecosystem and business landscape present a unique blend of opportunities and challenges for venture capital funds. While ongoing global geopolitical tensions and evolving regulatory frameworks require vigilant navigation, the potential for lucrative investments and impact opportunities remains robust.

Emerging from 2024, the Swedish market has demonstrated renewed momentum, showcasing its capacity for recovery and innovation. The positive rebound witnessed in the latter half of 2024 and start of 2025 has instilled confidence in investors, particularly in sectors that align with Sweden's strategic emphasis on technological advancement and environmental responsibility. This focus not only enhances the attractiveness of Swedish start-ups but also positions them favourably in the eyes of global investors seeking sustainable and impactful opportunities.

Venture capitalists can expect a dynamic pipeline of domestic and cross-border transactions, with numerous start-ups and established firms looking to leverage the Swedish market's strengths. By staying informed about emerging market trends and actively engaging with local networks, investors can identify promising ventures that align with their investment strategies.

SWITZERLAND

Law and Practice

Contributed by:
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1. Trends

1.1 VC Market

For financing rounds, the list of most sizeable transactions in 2024 is headed by the following:

- clinical stage biotech company Alentis Therapeutics, with its CHF160 million Series D financing round led by OrbiMed with co-leads Novo Holdings and Jeito Capital;
- clinical stage biotech company Asceneuron, with its CHF89.5 million Series C financing round led by Novo Holdings; and
- clinical stage biotech company Bright Peak Therapeutics' with its CHF80 million Series C financing round led by Johnson & Johnson Innovation JJDC.

With respect to exit transactions, the top two in terms of transaction value include the following:

- Cadence's acquisition of BETA CAE Systems International, providing multi-domain, engineering simulation solutions, for approximately USD1.24 billion; and
- the acquisition agreement of Swiss-Dutch biotech company Calypso Biotech with Novartis, with an upfront payment of USD250 million and development milestone payments of up to USD175 million.

There was no IPO in the venture capital market in 2024. However in February 2025, BioVersys AG, a multi-asset, clinical stage biopharmaceutical company completed its IPO on SIX Swiss Exchange.

(Numbers by Swiss Venture Capital Report 2025 published by startupticker.ch and SECA – Swiss Private Equity & Corporate Finance Association.)

1.2 Key Trends

In 2024, the number of financing rounds of Swiss start-ups declined by 10.1% while the total amount of capital invested decreased by 8.5% compared to 2023. The number of exits remained at the low level of 2023 with even fewer Swiss companies acquiring start-ups. Despite this overall decline, there was a 40.7% increase in median financing amounts, reaching a record CHF3 million across all rounds.

Later-stage investments remained relatively stable in volume, but the number of financing rounds declined by about 10%. In contrast, there was a noticeable decline in the number of transactions in early-stage companies, but with an increased total investment volume (indicating larger investments). For seed investments, both the investment volume and the number of transactions decreased considerably (-19% and -11%, respectively).

Although the total invested amount in the top 20 financing rounds dropped by 18.1%, 31 mid-sized growth companies were able to secure more than CHF20 million (compared to 29 in 2023).

(Numbers by Swiss Venture Capital Report 2025 published by startupticker.ch and SECA – Swiss Private Equity & Corporate Finance Association.)

Similar to other jurisdictions, there has been a significant number of downrounds and recapitalisations, a stronger focus of investors on profitability and several cashless exits in which shareholders had to roll-over their shares into shares of the buyer.

1.3 Key Industries

Traditionally, venture capital activity in Switzerland has been driven by ICT, fintech and bio-

tech companies, which together accounted for two-thirds to three-quarters of the total investment volume in the previous years. However, a further drop in investment volumes in both the general ICT sector (-12.9%) and the fintech sector (-51.5%) was observed. In particular, large investments in fintech companies were almost non-existent.

The biotech sector, on the other hand, made a strong recovery. In 2024, CHF739.2 million was invested in this sector – more than 50% higher than in 2023 and only slightly below the record set in 2020. Biotech investments accounted for 31% of all invested amounts, while the healthcare sector as a whole accounted for 41.8%.

Cleantech companies set a new record for financing rounds and were well-represented in the largest rounds in 2024. This trend towards deeptech is generally reflected in increased investment activity in robotics, healthcare and cleantech companies. (Numbers by Swiss Venture Capital Report 2025 published by startupticker.ch and SECA – Swiss Private Equity & Corporate Finance Association.)

2. Venture Capital Funds

2.1 Fund Structure

To date, venture capital funds managed and/or marketed in or from Switzerland typically have not been set up in Switzerland but in a foreign fund jurisdiction due to certain tax disadvantages and/or barriers to cross-border marketing of Swiss funds or other factors affecting managers' and investors' preferences.

If no exemption applies, venture capital fund structures established in Switzerland pooling assets from multiple investors generally qualify as collective investment schemes pursuant and subject to the Collective Investment Schemes Act (CISA) and its implementing ordinance, the Collective Investment Schemes Ordinance (CISO). In particular, investment companies in the form of a Swiss company limited by shares are not subject to the CISA if they are listed on an exchange in Switzerland or if only qualified investors pursuant to CISA are entitled to participate in the registered shares of an unlisted investment company. However, such exempt investment companies are subject to and must comply with the Anti-Money Laundering Act (AMLA) and are required to affiliate with a self-regulatory organisation (SRO) if not subject to supervision by the Swiss Financial Market Supervisory Authority FINMA (FINMA). Furthermore, a group of venture capital investors may pool their investments without qualifying as a collective investment scheme if they meet the criteria of an investment club according to Article 1a CISO, which requires that the membership rights are set out in the relevant constitutive document for the investment club's chosen legal status, the members or selected members take the investment decisions, the members are informed about the status of the investments on a regular basis, and the number of members does not exceed 20.

Fund structures subject to CISA may be open-end and closed-end. Open-end funds may be set up as contractual funds (FCP) or as investment companies with variable capital (SICAV). CISA distinguishes four types of open-end funds based on the type of investment:

- securities funds;
- real estate funds;
- other funds for traditional investments; and
- other funds for alternative investments.

Each type of fund follows a different set of rules regarding permitted investments, investment restrictions, investment techniques and disclosure requirements. According to the FINMA's current practice, an FCP or SICAV investing more than approximately 20–30% of its total assets in venture capital or other alternative investments needs to be set up as an *"other fund for alternative investments"*.

Closed-end funds may be set up as investment companies with fixed capital (SICAF) or as partnerships for collective capital investment (LPCI). Since the introduction of SICAFs in 2007, none have been authorised in Switzerland, mainly owing to the unfavourable tax treatment that leads to taxation at both the company and the investor level. An LPCI is a special form of limited partnership whose sole objective is a collective capital investment and which is reserved for qualified investors, similar to limited partnership fund structures in other jurisdictions. At least one member bears unlimited liability (general partner), while other members (limited partners) are liable only up to a specified amount (limited partner's contribution). General partners must be companies limited by shares, with their registered office in Switzerland. Limited partners must be qualified investors according to CISA. An LPCI may only manage its own investments and conducts investments in risk capital. The investments in companies or projects can take the form of equity capital, lending or mezzanine financing. Those sparse funds subject to CISA with venture capital investments have been set up and authorised as LPCI.

As of 1 March 2024, a new fund type, the Limited Qualified Investor Fund (L-QIF), which is exempt from any authorisation, approval and product supervision by FINMA and, therefore, significantly reduces set-up costs and time to market, has been introduced in the CISA/CISO. The L-QIF must be managed by a supervised Swiss fund management company or manager of collective assets and set up as one of the above-mentioned forms of Swiss collective investment schemes, except for the SICAF, which is not a permitted legal form for an L-QIF. The L-QIF is open only to qualified investors and provides for very liberal investment rules and risk diversification requirements to encourage innovation, similar to unregulated fund structures in other jurisdictions, such as the Reserved Alternative Investment Fund (RAIF) in Luxembourg. This flexible new fund structure (eg, in the form of an LPCI) could also be an efficient structuring solution for venture capital funds.

2.2 Fund Economics

Fund Principals, as investment managers or advisers to the venture capital fund, may charge a management fee and/or performance fee to the fund in accordance with the applicable provisions under CISA/CISO and the fund regulations. As an investor in their own venture capital fund, Fund Principals may participate in the economics of the fund only in accordance with the principle of equal treatment of all investors, which applies on the share class rather than the fund level. The rules of conduct of the Asset Management Association Switzerland (AMAS), which are recognised by FINMA as a minimum standard, specify the principle of equal treatment of investors and stipulate that fund management companies and other *"fund institutions"* must manage collective investment schemes in accordance with the principle of relative equal treatment, according to which objectively justified differentiations are permitted (eg, rebates to all investors meeting defined objective criteria). However, there are no established or evolving market standards in Switzerland with respect to key terms for Fund Principals.

2.3 Fund Regulation

Please see **2.1 Fund Structure**.

2.4 Particularities

As mentioned in **2.1 Fund Structure**, venture capital funds managed and/or marketed in or from Switzerland are typically not set up in Switzerland but in a foreign fund jurisdiction. It remains to be seen if the newly introduced fund type L-QIF will also be used to set up venture capital funds in Switzerland. Accordingly, no observations can be made in respect of specific VC fund structures emerging in response to certain market trends in Switzerland. However, the L-QIF regime in particular, would be well designed to support fund structures geared towards longer investment cycles, including long-duration closed-end funds, as well as secondaries and continuation vehicles for the purpose of providing a liquidity solution for existing investors.

3. Investments in Venture Capital Portfolio Companies

3.1 Due Diligence

Before investing in a company, VC investors would often conduct a legal, financial, commercial and tax due diligence, whereby the scope of such due diligence varies depending on the stage of the company, the size of the investment, and the industry and market in which the relevant company operates. In a legal due diligence, key areas that are generally covered include the following:

- title;
- employment;
- social security and pensions;
- tax;
- material agreements;
- intellectual property; and
- compliance and regulation.

3.2 Process

The timeline of a new equity financing round in a company depends on several factors, such as the complexity of the transaction, the due diligence process and the dynamics between the parties. On average it takes about two to four months from the signing of the term sheet until the registration of the capital increase in the commercial register. By contrast, the timeline for convertible loan rounds tends to be significantly shorter. Generally, the company and the lead investor are each represented by separate counsel but there are also (rare) instances where joint counsel is engaged to streamline the process and save costs. As a financing round in a Swiss entity requires the involvement of the existing shareholders – such as for the approval of the relevant capital increase, the waiver of statutory and contractual pre-emptive rights, and renegotiation of the shareholders' agreement including the rights of the existing investors – it is advisable to involve them sufficiently early in the process.

3.3 Investment Structure

Whereas a Swiss start-up would typically be incorporated with common shares only, preferred shares are commonly used in later financings, in particular from a seed or Series A stage onwards. Preferred shares are entitled to a liquidation preference in the event of a liquidation or sale of the company, ensuring that they receive a certain amount before any distributions are made to common shareholders. In most instances, a one-time non-participating liquidation preference is granted. Other rights that are typically linked to preferred shares are as follows:

- conversion rights;

- (special) pre-emptive subscription rights;
- down-round protection rights; and
- blocking/veto rights in relation to certain material corporate resolutions or a potential drag-along event.

3.4 Documentation

Certain key documents outline the terms of the investment typically used in the financing of a Swiss start-up. Depending on the parties involved and the complexity of the transaction, the specific documents may vary, but the most common documents include the following.

- Term sheet – This is a generally non-binding document (with certain exceptions, such as for exclusivity and costs) that sets forth the key details of an investment and the rights of the involved parties. It serves as a basis for negotiations and helps the parties to agree on the key terms before working with more detailed documents.
- Investment agreement – The investment agreement is entered into by the investors, existing shareholders and the company. It sets out:
  (a) the specific terms of the investment, including the investment amount as well as the number and category of shares issued;
  (b) details and steps in relation to the closing;
  (c) the representations and warranties given by the parties; and
  (d) the remedies in case of a breach.
- Shareholders' agreement – The shareholders agreement governs the relationship between the shareholders upon completion of the investment. It includes provisions governing:
  (a) the corporate governance, including board appointment, and veto and information rights;
  (b) pre-emptive subscription rights;
  (c) sale and liquidation preference and conversion rights;
  (d) down-round protection rights;
  (e) non-compete and non-solicitation provision; and
  (f) the restrictions on share transfers as well as drag-along and tag-along rights.

The Swiss Private Equity & Corporate Finance Association (SECA) provides model documentation for VC investments, including the aforementioned documents. However, the SECA templates are generally not considered a reflection of the market standard, and most law firms that are active in the market use their own templates.

3.5 Investor Safeguards

To protect their investment, VC investors often secure certain key terms in a downside scenario, such as liquidation or a down-round. Besides the liquidation preference (see **3.3 Investment Structure**), such terms include the following.

- Anti-dilution adjustments – Anti-dilution provisions serve to protect investors from dilution of their stake in the company in subsequent rounds of financing at lower valuations. Most commonly, a broad-based weighted average adjustment would be agreed which would be effected by the issuance of additional shares of the same category at nominal value to the affected parties. Sometimes, the issuance of such shares is subject to pay-to-play provisions.
- Pre-emptive subscription rights – Pre-emptive subscription rights give investors the opportunity to maintain their ownership percentage in the company by purchasing additional shares on a pro rata basis before they are offered to other investors. In the majority of cases, such right is limited to the investors'

pro rata portion and gives neither a general pre-emptive right prevailing over existing shareholders nor the right for any overallocation of non-exercised subscription rights.
- Control or veto rights – VC investors often have control rights to influence key decisions at the shareholder level as well as at the board level.
- Vesting and claw-back – In order to ensure the founders' and other key personnel's commitments vis-à-vis the company, VC investors often require that such persons are bound by (reverse) vesting provisions structured as call-options applicable in case of an early termination of the employment or service relationship.

3.6 Corporate Governance

Investors often ask for the right to appoint one or more representatives to the company's board of directors. Board representation allows the investors to influence key strategic decisions (often investor directors have veto rights in relation to certain strategic decisions), and monitor the management as well as the activities of the company. The day-to-day management of the company is typically delegated to the executive board members/the management in accordance with the terms of organisational regulations. If an investor is not allowed (eg, for regulatory or tax reasons) or otherwise unable to appoint a board member, it is also possible to appoint a board observer having the same information and participation rights as a board member, but no voting rights.

3.7 Contractual Protection

In a financing round, a VC investor would generally ask for representations and warranties from the company and/or the founders covering, inter alia:

- ownership and qualification;
- due authorisation;
- financial statements and subsequent events;
- insurance;
- compliance;
- intellectual property;
- material agreements;
- employment, social security and pension;
- litigation; and
- no broker's fee.

In most financing rounds, a fair disclosure concept is agreed, whereby the documents included in a virtual data room are generally deemed disclosed vis-à-vis the investors. In some instances, the representing parties may be asked to provide a disclosure letter. Swiss law imposes restrictions on the payment of damages resulting from an investment by the company. Hence investors would typically be indemnified by virtue of a compensatory capital increase, which means the issuance of additional shares of the category initially subscribed at nominal value.

4. Government Inducements

4.1 Subsidy Programmes

There are numerous government-backed initiatives providing non-dilutive funding or government-guaranteed loans to Swiss start-ups such as the Innosuisse programme and the Swiss Technology Fund, which may also provide an indirect incentive for equity investment. However, there are no sizeable programmes directly subsidising equity investment in Swiss start-up companies.

4.2 Tax Treatment

The tax treatment of an investment in start-up/VC fund portfolio companies is generally the same as the tax treatment in any other company.

Stamp Duty

Equity contributions to Swiss companies are subject to a 1% issuance stamp duty payable by the company. The issuance of newly created shares up to CHF1 million are exempt therefrom.

Capital Contribution Reserves

To the extent such contributions exceed the nominal value of shares created, they can be earmarked as capital contribution reserves allowing for their redistribution to shareholders without triggering Swiss withholding tax and income tax on the level of investors holding their shares as private assets. These capital contribution reserves need to be reported to and confirmed by the Swiss Federal Tax Administration (SFTA).

Dividend Distribution

Dividend distributions not made out of or in excess of such confirmed capital contribution reserves (which are rarely made in the context of VC portfolio companies) would be subject to 35% Swiss withholding tax.

Refund of Swiss Withholding Tax

Swiss withholding tax will be fully refundable or creditable to a Swiss tax resident corporate and individual shareholder (as well as to a non-Swiss tax resident corporate or individual shareholder who holds the shares through a Swiss branch office) if such a recipient is the beneficial owner of the distribution received and the income is recognised in the income statement or reported in the income tax return of the recipient. Shareholders who are not resident in Switzerland for tax purposes (and who do not conduct a trade or business through a Swiss branch office) may be entitled to a full or partial refund of Swiss withholding tax if the country in which such a recipient resides for tax purposes has concluded a double tax treaty (DTT) with Switzerland and further conditions of such a DTT are met. Under certain circumstances, a full refund is also conceivable under the Agreement between the European Union and the Swiss Confederation on the automatic exchange of financial account information to improve international tax compliance (AEI Agreement Switzerland-EU).

Capital Gains

Upon a sale of their shares, foreign resident investors are generally not subject to Swiss capital gains tax or withholding tax according to Swiss domestic law and applicable DTT. Furthermore, gains resulting from the sale of shares are generally tax-free for Swiss resident founders and Swiss-based non-professional private investors (individuals). For Swiss resident professional or corporate investors, capital gains derived from the sale of shares are generally subject to corporate income tax and capital losses are tax-deductible. The participation exemption applies to capital gains derived from a disposal of a qualifying participation of at least 10%, provided that the minimum holding period of one year is met and leads to a virtual tax exemption of such qualifying capital gains. However, recaptured depreciations (the difference between the acquisition costs and book value) on such qualifying participations are subject to ordinary taxation. Tax losses may be carried forward for the next seven years.

Convertible Loans (CLAs)

Convertible loans (CLAs) are instruments frequently used to provide start-ups with funding in Switzerland. If a CLA qualifies as a private loan, the SFTA does not levy withholding tax on interest payments. The interest payments due to the lender are subject to income or profit tax.

However, if a company issues CLAs (for an amount of more than CHF500,000 in total) and applies the same terms (interest, conversion

discount, currency, term, etc) on these CLAs to more than ten (non-bank) lenders or issues CLAs with different terms to more than 20 (non-bank) lenders in total (so-called 10/20-non-bank-rules), the SFTA qualifies the CLAs as convertible bonds and levies withholding tax on the interest payments when the interest is due.

Furthermore, the SFTA in practice generally also qualifies the convertible discount as an interest payment and levies income and withholding tax on it if the 10/20 non-bank rules are not observed, unless it qualifies the CLA as *"classic"* CLA. Pursuant the current practice of the SFTA, a CLA with a conversion discount of more than 20% no longer qualifies as *"classic"* CLA. For the refund of the withholding tax, see above.

Upon conversion of a CLA, stamp duty will be due (see above) on the amount that is converted to equity.

Furthermore, Swiss withholding tax is due irrespective of the qualification as a convertible bond, if the interest is requalified as a constructive dividend. This is the case if the loan CLA is held by an existing shareholder or a related party, and the interest on the CLA is not at arm's length according to the rules set out by the SFTA (the SFTA publishes safe haven rates every year) or if the company is thinly capitalised for tax purposes. An exception may apply to PIK interest (ie, interest that is paid in the form of additional shares upon conversion of the CLA instead of a cash settlement).

4.3 Government Endorsement

See **4.1 Subsidy Programmes**.

5. Employment Incentives

5.1 General

The long-term commitment of the founders and other key employees to the venture is crucial for the success and the sustainable development of the company. This commitment is often procured by offering key employees equity or virtual equity in the company. A (virtual) equity participation ensures that the interests and efforts of the relevant beneficiary are aligned with the long-term success of the company. In some instances, a start-up would also grant monetary performance-based incentives: in particular, bonuses to its key personnel. Non-compete and non-solicitation arrangements with key personnel, which serve to protect the company's intellectual property and trade secrets as well as the relationship with both customers and other personnel, are prevalent in Switzerland.

5.2 Securities

Swiss companies use various instruments to incentivise their key personnel. The most prevalent ones are share plans, stock options plans and virtual share plans. In a share plan, beneficiaries are granted shares and thus directly and immediately participate in the equity capital of the company. In a stock option plan, the employees are granted the right to acquire employee shares within a defined period (exercise period) at a certain price (exercise price). Often, companies would opt to implement a virtual share plan, which means that the beneficiaries are granted virtual shares only, which reflect the value of a certain category of share (typically common stock), and, from a monetary perspective, generally equates their holders to the holders of such category of (real) shares. However, holders of virtual shares neither hold a stake in the company nor have any shareholder rights.

The main advantage of a share and stock options plan is the leeway for tax-optimisation (see **5.3 Taxation of Instruments**). However, they create an increased administrative burden due to the need for rulings and discussion with the tax authorities, certification obligations vis-à-vis tax authorities and the financing and structuring of the corresponding option and share issuance, respectively. In addition, as the relevant beneficiaries become shareholders with full voting and information rights, it will have to be ensured that they are set in an appropriate governance framework, including a shareholders' agreement that outlines their rights and obligations. Virtual share plans, on the other hand, are quick, cheap and easy to implement and maintain. However, in most instances they are not the most tax-optimised option.

5.3 Taxation of Instruments

As a general rule, for Swiss tax residents, capital gains from the sale of privately held shares are tax free under Swiss law. However, this does not apply to capital gains from the sale of privately held employee shares of beneficiaries (ie, shares which are transferred to the employee in connection with the employment relationship), unless it can be proven that such transfer occurred at fair market value (which is typically not the case with non-listed shares).

In practice, employee shares are rewarded at a recognised formula, which is often pre-agreed with the authorities and which typically leads to a moderate valuation of the relevant shares at the time of their acquisition or exercise of options to determine the taxable salary component. In case of an exit, the same formula will be used to determine the part of the exit price which is deemed tax-free, thereby using the most recent financial parameters at exit for the purpose of the formula. Accordingly, a relevant beneficiary can then benefit from a tax-free capital gain in an amount corresponding to the difference between the formula value at the date of acquisition and the formula value calculated based on the same valuation method at the time of the disposal. Any additional increase in value (*"excess profit"*;*Übergewinn*); ie, the difference between the actual exit price and the formula value at the time of the disposal, constitutes taxable income.

As per the current tax practice in the cantons, the *"excess profit"* will also be treated as a tax-free capital gain after a holding period of five years. Considering the above-mentioned principles, key factors when structuring a share and/or a stock option pool thus include the determination of a formula that is equally suitable at the time of grant and at the time of exit, and finding an appropriate (reverse) vesting schedule, thereby taking into consideration the timing of a potential exit as well as the development of the financial parameters used for the purpose of the formula until then.

On the other hand, monetary benefits from virtual share plans are fully taxable and subject to social contributions at the time of their payment – ie, generally a liquidity event. No tax-free capital gains can hence be derived from virtual stock option plans.

The applicable tax rate varies depending on the canton and municipality where such employee is based and generally does not have a major impact on the structuring of an incentive pool at the company level.

5.4 Implementation

Typically, the investors will insist that, as part of the financing round, an incentive programme will be set up or a current programme be increased, to ensure that a reasonable and unallocated

pool is available to cover the company's needs for a reasonable period following closing. Main terms and size of the pool are then agreed in the financing round documentation. It is thereby possible to wholly or partially consider this pool/its increase as pre-existing for the calculation of the share price of investors based on a fully diluted pre-money valuation or to agree that the relevant dilution shall be borne by all shareholders (including new investors).

6. Exits

6.1 Investor Exit Rights

The shareholders' agreements provide for certain exit rules relating to trade sale or IPO transactions, often through covenants to pursue such a transaction if approved by the board or by a qualified majority of the shareholders. IPO-related clauses usually cover registration rights in case of US listings as well as lock-up undertakings (often 6–18 months and depending on underwriting recommendation or requests).

The shareholders' agreement also typically provides for a set of transfer restrictions applicable to all shareholders, including:

- a prohibition on encumbrances;
- right of first offer or refusal of existing shareholders;
- co-sale rights (tag-along) and co-sale obligations (drag-along); and
- call options of the company and/or other shareholders (eg, in case of an insolvency event with respect to a shareholder, transfer or encumbrance of shares in breach of transfer restrictions or other material breaches of the shareholders' agreement, in all instances excluding transfers explicitly permitted or provided for in the shareholders' agreement such as – eg, affiliate transfers).

The tag-along right is usually limited to a pro rata portion in case the respective sale transaction does not trigger a change of control. There are also instances where the pro rata tag along is restricted to certain categories of shareholders or excluded altogether. Typically, the approval of a qualified majority of all shareholders as well as a majority of preferred shareholders is required to trigger the drag-along obligation. Sometimes the latter majority will not apply if proceeds from the sale exceed a certain threshold (eg, two or three times the issue price in the last financing round).

In case of a trade sale, investors holding preferred shares are entitled to their respective liquidation preference (see **3.3 Investment Structure**) with later-stage preferred shares often ranking senior to those issued in previous rounds, provided that they may instead opt for distribution of proceeds on an *"as-if converted"* basis, if distributions due to common shares exceed the preference amount for the respective class of preferred shares.

Whereas it is rather uncommon to grant investors the right to trigger an exit alone, it is from time to time agreed that investors will have a preferred liquidity upon expiration of a certain period (eg, by carve-outs from the tag-along and right of first refusal provisions) and/or that they may request that exit options (trade sale or IPO/listing) are at least evaluated with the help of external advisers upon expiration of such a period.

In case of late-stage projects, the shareholders' agreement would typically also include specific provisions facilitating any IPO or listing.

6.2 IPO Exits

IPOs of Swiss start-ups are rather rare when compared with trade sale exits. After a record of 11 IPOs in 2021, the number of IPOs dropped to four and one in 2022 and 2023, respectively.

Whilst Swiss start-ups still frequently seek out US trading venues (NYSE and Nasdaq) for their IPO, SIX Swiss Exchange, including Sparks, its stock market segment for fast-growing small and medium-sized companies newly introduced in 2021, has gained some traction.

In case of an IPO, mostly primary shares are being offered and listed, occasionally combined with exit (sale) opportunities at the IPO for select investors (secondary tranche). Lock-up undertakings limit quick exits for remaining shareholders affiliated with the issuer (mostly key employees, founders and certain other main shareholders).

6.3 Pre-IPO Liquidity

Particularly late-stage start-ups often and regularly conduct orchestrated secondary rounds, typically as part of or in connection with financing rounds to accommodate the request for liquidity of early-stage investors and sometimes also founders and other employees. Respective shares are often purchased by new investors at a certain discount to the price applied in the financing round. Occasionally, such shares are also converted into the preferred shares issued in such round.

7. Regulation

7.1 Securities Offerings

The Swiss Financial Services Act (FinSA) provides that a prospectus must be published for a public offering of securities in Switzerland or for securities to be admitted to trading on a Swiss trading venue. As a general rule, such prospectus needs to be approved by an accredited prospectus review body (currently there are two, managed by SIX Swiss Exchange and BX Swiss, respectively).

An offering is deemed public (and no longer private) if it is directed to the general public – ie, not clearly limited to a predetermined, relatively homogeneous group of investors. However, there are various exemptions from the prospectus requirement even if an offering qualifies as a public offering. For example, no prospectus requirement applies if:

- the offering is limited to persons qualifying as professional clients according to FinSA;
- the offering is targeting fewer than 500 potential investors;
- the offering is for securities with a minimum denomination of more than CHF100,000 or requires investors to subscribe for securities for at least that amount;
- the total value of the offering does not exceed CHF8 million within a rolling 12-month period; and
- securities are offered by an employer or affiliated company to current or former members of the board, executive management or their employees.

Crowd financings aside, it is therefore usually possible to structure venture capital financing rounds and secondary transactions in a manner that does not trigger the prospectus requirement. In larger projects with an international investor base, secondary transactions are often made compliant with US securities law.

7.2 Restrictions

Competition Law and Merger Control

The Swiss Cartel Act provides for a notification obligation to the Swiss competition commission (CompCo) in case of one or several investors obtaining sole or joint control over a Swiss company, provided that: (i) the relevant turnover thresholds are met; or (ii) CompCo has previously established that at least one of the investors concerned holds a dominant position on a certain market in Switzerland and the investment concerns that or a neighbouring market.

Joint control does not necessarily require a majority in terms of voting rights or board representation but may also be achieved through sufficiently broad veto rights (as commonly seen in shareholders' agreements) if these are granted to individual investors or a specific group of investors in a manner that no longer allows for changing majorities.

The turnover thresholds are met if in the business year preceding the investment either (i) one of the investors reached a total turnover of at least CHF2 billion or a turnover in Switzerland of at least CHF500 million or (ii) at least two investors reached a turnover in Switzerland of at least CHF100 million, in each case applying a group perspective.

Therefore, the application of merger control regulations should be carefully assessed, in particular when dealing with strategic investors or their venture arms. Furthermore, competition law issues may also arise with respect to non-compete and non-solicitation undertakings in shareholders' agreements.

FDI Regulation

Switzerland has so far not implemented a comprehensive foreign investment control regime. In December 2023, the Swiss Federal Council published a draft for a Federal Act on the Control of Foreign Investments, which has yet to pass parliament (and a potential referendum). The scope of the draft legislation is limited to investment by state-controlled foreign investors in certain particularly critical industries. Furthermore, the draft envisages turnover thresholds.

In addition, there are restrictions that can impact foreign investment in certain specific sectors already in force. For example, the Federal Act on the Acquisition of Real Estate by Persons Abroad (Lex Koller) provides for restrictions on the (direct or indirect) acquisition of real estate that is not used as a permanent establishment of a commercial, manufacturing or other business by non-Swiss persons or entities, which may affect the sale or issuance of shares to foreign investors in certain instances. As another example, pursuant to the Federal Act on Banks and Savings Banks, additional authorisation from the FINMA is required if a Swiss bank becomes foreign-controlled after its establishment.

Financial Market Regulation

Broadly speaking, financial services regulations may impose restrictions and regulatory requirements on venture capital investment structured as collective investment schemes or on activities that go beyond the realm of corporate financing and qualifying as financial services.

Trends and Developments

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Kellerhals Carrard is a leading Swiss law firm serving clients from diverse sectors such as energy and natural resources, financial services and insurance, industry and trade, public sector and procurement, healthcare and life sciences, and private equity. The firm is characterised by an interdisciplinary mindset, a strong team spirit, and the dedication to provide optimum solutions tailored to its clients. It has a presence in all the language regions of Switzerland and a strong international network. With a strong focus on supporting start-ups and venture capital (VC), the Startup and VC Desk at Kellerhals Carrard provides comprehensive legal advice for innovative entrepreneurs in Switzerland. The team consists of experienced lawyers who specialise in the needs of start-ups and offer tailored solutions, and the firm is highly rated globally for its VC work in the country and region.

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Introduction

In line with trends in other markets, Switzerland has seen two challenging years in 2023 and 2024: Key parameters for the Swiss venture capital market, such as amount of invested capital and number of financing rounds and exits, further declined in 2024 compared to an already weak 2023. But despite the bleak figures, the Swiss start-up ecosystem has demonstrated more robustness and resilience in the face of global economic uncertainties than ever before. This was evidenced by various factors in 2024, including the significant surge of biotech and cleantech investments, increased median investment amounts across all stages and clearly renewed optimistic outlooks by investors. As such, Switzerland remains one of Europe's top destinations for venture capital investments, particularly in deep tech sectors, and 2025 is likely bound to become a pivotal year with recoveries across the board.

Market Developments

Financing rounds

The Swiss Venture Capital Report 2025 reveals a dynamic landscape for financing rounds in Switzerland. In 2024, the total amount invested in Swiss start-ups was CHF2.369 billion, spread across 357 financing rounds. This represents a slight decline compared to previous years but remains significantly higher than pre-pandemic levels.

One notable trend is the increasing median investment size across all stages. The median investment in seed rounds remained stable at CHF1.4 million, while early-stage rounds saw a substantial increase from CHF2.4 million to CHF4.3 million. Later-stage rounds also experienced growth, with the median investment rising from CHF6.3 million to CHF12 million. This indicates a consolidation among start-ups, with fewer rounds but larger investments, suggesting a focus on scaling and growth.

The report also highlights the geographical distribution of investments within Switzerland. While Zurich remains the leading region in terms of the number of financing rounds and total capital invested, other regions such as Vaud, Geneva and Zug have shown significant growth. This regional diversification is a positive sign, indicating that the Swiss start-up ecosystem has become more balanced and inclusive.

What remains interesting to note is that both the numbers of financing rounds (across all stages) as well as the amount of invested capital of spin-offs from ETH Zurich has, contrary to the general market trend in Switzerland, seen an upward development, underlining Switzerland's position as a deep tech hub. More on that further below.

Sector-specific insights

As mentioned, the biotech sector emerged as a frontrunner, with CHF739.2 million invested in 2024, marking a 50% increase compared to the previous year and less than 10% below the previous record set in 2020. This sector's resilience and potential for innovation have made it a focal point for investors. Notably, biotech start-ups accounted for four of the five largest financing rounds in 2024, and the significant recovery of this sector could well be foreboding for other sectors.

The medtech sector also showed promise, with the invested amounts showing an upward trend in a multi-year comparison, and the number of financing rounds in healthcare IT having reached new records, mostly fuelled by seed-stage investments.

Cleantech demonstrated an extraordinarily strong performance with the total amount invested being at CHF471.9 million and with a new record number of financing rounds. This reflects the sector's ability to attract large investments despite challenging conditions. Seven of the top 20 investments were in cleantech start-ups, underscoring the growing importance of sustainable technologies.

Other sectors, such as ICT (including fintech) and healthcare IT, faced declines in investment. Fintech investments halved, while ICT investments fell by 12.9%. However, the early-stage rounds in ICT saw a significant increase in volume, indicating a shift towards nurturing emerging technologies. This trend suggests that while mature sectors may face challenges, there is still strong investor interest in innovative and disruptive technologies.

Low exit activities in 2024

Exits are a critical component of the VC ecosystem, providing returns to investors and enabling start-ups to scale further. The Swiss Venture Capital Report 2025 indicates a mixed picture in that regard with numbers remaining at the low level of 2023. Nonetheless, there were some notable transactions; for instance, Calypso Biotech was acquired by Novartis for USD250 million, and Viventis Microscopy was taken over by Leica Microsystems.

The report also highlights the importance of international buyers in the Swiss exit landscape. Acquirers from the US, Germany and other countries played a significant role in acquiring Swiss start-ups. This international interest underscores the global competitiveness of Swiss start-ups and their ability to attract foreign investment. However, the overall exit environment remains challenging. The number of initial public offerings (IPOs) has been limited, and many start-ups are finding it difficult to achieve the valuations needed for successful exits. Judging by investor surveys conducted at the end of December 2024, 2025 is set to see not only more investments and higher valuations but also larger numbers of exit transactions. Araris Biotech seems to pave the way with its sale in Q1/2025 to Tokyo-based pharmaceutical company Taiho for around USD1.14 billion.

Key Trends in the Swiss Start-Up and VC Ecosystem

Deep tech nation Switzerland

Over the past 20 years, Switzerland has emerged as a global leader in deep tech, which the European Deeptech Report defines as the sectors with *"novel scientific or engineering breakthroughs making their way into products and companies for the first time"*. Key differences to regular tech are longer development cycles, higher capital intensity, and a higher technological risk.

Switzerland attracted approximately USD500 million in deep tech VC funding in 2024, showing 45% year-on-year growth. This places Switzerland among the top countries in Europe for deep tech investments, with the Zurich region being highlighted as one of the main deep tech hubs, alongside cities like London, Paris, and Munich.

The country's competitive advantage in this field stems from its highly educated workforce, renowned research institutions, and strategic location at the heart of European markets; features that have also caused a high number of global tech companies to set up European headquarters or research teams in Switzerland, including Apple, Google, Huawei, AWS, Meta, Disney, Palantir, IBM and others. Private accelerator programmes, prime among them

venturekick, and the Swiss government with agencies like Innosuisse, have strategically focused on deep tech sectors through funding programmes, technology transfer initiatives, and start-up incubation efforts. By combining top-notch research with entrepreneurial drive, Switzerland has become a natural hub for industries such as robotics, computer vision, AI, cleantech, biotech, foodtech, fintech and advanced manufacturing.

As such, it does not come as a surprise that Switzerland boasts a high density of deep tech start-ups, with a significant proportion of founders holding PhDs. Based on a recent report, the density of start-ups with patents is twice as high as in Sweden and five times higher than in Germany. This emphasis on deep tech and innovation positions Switzerland as a leader in innovative technologies, also reflecting that Switzerland has ranked first in the Global Innovation Index for over a decade.

The presence of world-class research institutions has been instrumental in fostering such a culture of innovation and entrepreneurship. These institutions, consistently ranked among the top in global academic rankings in fields such as engineering, computer science and biotechnology, provide a steady stream of talent and cutting-edge research, which are critical for the development of deep tech start-ups.

ETH Zurich, for example, has been instrumental in the development of numerous deep tech start-ups and has a long-standing tradition of creating successful spin-offs. Over the past 51 years, ETH Zurich has awarded the spin-off label to a total of 615 companies. Notably, the last few years have set the highest numbers in terms of spin-offs, with 43 spin-offs in 2023 and 37 in 2024, which globally is highly competitive. Its strong emphasis on interdisciplinary research and collaboration has led to breakthroughs in areas such as AI, robotics, quantum computing, biotech and advanced materials. EPFL, located in Lausanne, has similarly contributed to the deep tech ecosystem. ETH Zurich and EPFL both rank among the top four European universities which created most deep tech spin-off value according to the latest European Deep Tech Report 2025.

Switzerland's continued shift to a deep tech nation is also underlined by the recently inaugurated Deep Tech Nation Switzerland Foundation, a private initiative of Swisscom and UBS and supported meanwhile by companies such as Swiss Re, Rolex, Julius Baer, SIX, Vaudoise Assurances, SICPA and the University of Zurich, with the aim to enhance the framework conditions for Swiss start-ups, scale-ups and investors in the deep tech sector, thereby strengthening Switzerland's innovation and competitiveness in the long term. The foundation's goal is to mobilise CHF5 billion in annual funding over ten years, with 50% coming from Swiss investors, potentially creating up to 100,000 new jobs indirectly.

Continued dominance of foreign capital

One of the key features of the Swiss VC ecosystem is its international orientation. Between 2014 and 2023, only 24% of the total venture capital came from Swiss investors, with US investors being the largest contributors, accounting for 35% of the capital. Conversely, Swiss investors also invest significantly abroad, with 37% of their funds going to US start-ups. This cross-border investment dynamic highlights the global interconnectedness of the Swiss start-up ecosystem and its ability to attract foreign capital even during crises.

The internationalisation of the Swiss start-up ecosystem has several positive implications. It enhances the stability of the ecosystem by providing access to a broader pool of capital, reducing reliance on domestic funding sources. This diversification of funding sources mitigates risks associated with economic downturns and market fluctuations. Additionally, the presence of foreign investors fosters a competitive environment, encouraging Swiss start-ups to strive for excellence and innovation. The global interconnectedness of the ecosystem also facilitates knowledge exchange and collaboration, driving the development of cutting-edge technologies and solutions.

Challenges and areas for improvement

Despite its strengths, the Swiss start-up ecosystem faces several challenges.

Growth financing

As mentioned previously, Switzerland has emerged as a centre of world-class innovation, especially in deep tech. Despite the region's exceptional technical talent and ground-breaking research, it has yet to produce global leaders in these transformative fields. To address this gap, it is essential to increase late-stage capital, prioritise global leadership over regional excellence, and build a robust support ecosystem to transform cutting-edge research into market-leading solutions. The notable gap in growth financing, particularly for large-scale investments, seems among the most pressing challenges in this respect. It remains to be seen if 2025 will be the year where such rounds resurface. While it is encouraging to see that at the end of 2024, almost 50 funds from VCs operating in Switzerland were in fundraising mode, many of them are smaller to mid-sized funds, thus not able to address the need for growth financings, thereby underlining the continued dependence of the Swiss start-up ecosystem on foreign investors.

Exit opportunities/FDI control

The number of exits remains low, and enhancing exit opportunities through strategic partnerships and acquisitions is essential. Switzerland is one of the world's largest recipients of foreign investments and one of the world's largest investors abroad. Accordingly, Switzerland has so far maintained a policy of openness towards foreign investment. Currently, there is no generally applicable law regarding the screening of foreign investments. There are, however, sectoral laws regulating or restricting foreign investments, particularly in the banking and real estate sectors, and in telecommunications, nuclear energy, radio and television, and aviation. More importantly, the Federal Parliament is currently considering tightening the rules by subjecting foreign buyers to greater scrutiny in Switzerland. Although foreign investments would remain permitted in principle, they would now be subject to authorisation under certain conditions, especially in the event of security concerns. By applying such a regime to any buyer, and not only those that were state-controlled, exits of Swiss companies would become more complicated, thereby possibly dampening increased M&A activities.

Job creation

Swiss start-ups tend to create fewer jobs compared to their counterparts in other countries. Fostering job creation and scaling operations can enhance the overall impact of the ecosystem. The report suggests that providing targeted support for high-growth start-ups and promoting policies that encourage job creation could help address this issue.

Access to technology

Switzerland has recently and surprisingly been excluded by the USA from the list of allied countries for unlimited access to chips required for artificial intelligence. While efforts are currently underway on the part of the Swiss government to remedy this situation, this development is a testament to potential vulnerabilities that countries like Switzerland may be confronted with as part of a world that is increasingly caught in geopolitical tensions.

Harmonisation of spin-off terms

Swiss universities typically follow a general framework for spin-off terms, which includes the grant of (exclusive) licence rights in exchange for royalties that are usually revenue-based and for equity stakes which are usually in the region of 10% or less. These frameworks are designed to ensure that spin-offs can effectively commercialise academic research while providing fair returns to the universities. Transparency around deal terms and efficiency of negotiations has strongly increased over the past years, reflecting the universities' awareness regarding their critical role as enablers of entrepreneurial activities in the deep tech space. However, achieving full harmonisation remains a challenge. Efforts to standardise guidelines, share best practices, and provide support for founders can help improve the process and ensure that spin-offs can effectively commercialise academic research. By addressing these challenges, Swiss universities can continue to foster innovation and entrepreneurship, contributing to the growth of the country's tech ecosystem.

Conclusion and Outlook

The Swiss start-up and venture capital ecosystem is characterised by its strong focus on deep tech, significant international investment dynamics, and resilience in the face of economic challenges. As the ecosystem continues to evolve, staying abreast of market trends and leveraging opportunities in deep tech and sustainability will be essential for fostering innovation and growth.

The year 2025 is expected to be a pivotal one for the Swiss start-up ecosystem. Despite the challenges faced in previous years, there is optimism for a recovery and growth. Recent surveys indicate that while the total investment volume has declined, sectors like biotech, cleantech, robotics and AI are poised for significant growth.

The resilience of the Swiss start-up ecosystem, coupled with its ability to attract foreign capital, provides a solid foundation for future growth. As global economic conditions improve, there is potential for increased investment activity and the emergence of new market leaders originating from Switzerland. Efforts that continue to focus on bridging the gap in growth financing and fostering large-scale investments will be essential for scaling operations and driving economic impact.

The current geopolitical challenges may turn out to have a fundamental boosting effect in this regard. To quote Klaus Hommels from Lakestar in the latest European Deep Tech Report: *"Deep Tech will be the engine of Europe's next wave of innovation, driving breakthroughs from autonomous systems to space technologies. If European defence spending rises to the estimated 3.5% of GDP, we expect around 10% of that – roughly EUR61 billion per year – to be directly invested in European Deep Tech. With an assumed 4x revenue multiple, this would translate to an annual market impact of EUR245 billion. This investment will extend far beyond pure-play defence applications, fuelling advances across the entire Deep Tech ecosystem and reinforcing Europe's technological sovereignty and global competi-*

tiveness." Even if defence spending in Switzerland may not reach the levels of its European counterparts, it seems safe to assume that there will be substantial spillover effects for the Swiss deep tech ecosystem and its start-ups.

In conclusion, the Swiss VC market is well-positioned to continue its trajectory of growth and innovation. By addressing key challenges and leveraging its strengths, Switzerland can solidify its position as a global hotspot for venture capital and entrepreneurship, especially in the deep tech area.

TAIWAN

Law and Practice

Contributed by:
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Lee and Li, Attorneys-at-Law is a leading full-service law firm with specialisations which include banking and finance, capital markets, corporate and investment, litigation and dispute resolution, patents and technology, and trade marks and copyrights. The firm regularly advises venture capital, private equity, and institutional investors on a wide range of industries in Taiwan, including AI, fintech, cryptocurrencies, AIoT, SaaS, e-commerce, biotechnology and digital health. Apart from supporting the formation of reputable local venture capital funds such as Taiwania and JAFCO, Lee and Li provides assistance to Taiwanese venture capitalists in their start-up investments, including Taiwania, CDIB, JAFCO, WI Harper, and others. It also actively assists entrepreneurs with financing and IPO planning. In recent years, the firm has participated in several *"de-SPAC transactions"*, which enable Taiwan companies to be listed on US stock exchanges. Some of the companies the firm has helped list include Perfect Corp. (NYSE), Gorilla Technology (NASDAQ), Semilux International Ltd. (NASDAQ), TNL Mediagene (NASDAQ) and FST Corp. (NASDAQ).

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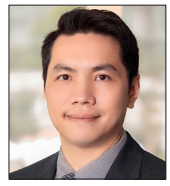

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1. Trends

1.1 VC Market

Despite the downturn that was expected for the end of 2022 and early 2023 and a subdued market for VC investments globally in 2024, according to a StartBlink 2024 Report, Taiwan's start-up ecosystem thrived and experienced an increase in 2023 and 2024 and became the top 22nd start-up ecosystem in 2024, advancing two places from 24th in 2023. The growth can be credited to various factors, such as start-up friendly government programmes, the increased investment in start-ups by the National Development Fund (NDF), the continuing promotion of IPO platforms for start-ups by the Taiwan Stock Exchange (TWSE), active participation and funding from corporate venture capital funds (CVCs) and the continued thriving of the AI and semiconductor industries. There was significant growth in the number of IPOs (67 companies) and the IPO proceeds (TWD57.6 billion (around USD192 million)) in 2024 as compared to 2023 (45 IPO companies with IPO proceeds of TWD37.9 billion (around USD126 million).

One of the most notable events was the listing of Diamond Biofund Inc. on the Main Board of the TWSE in 2023, which is the very first listing of a large-scale, sustainable, biotech venture capital fund specialising in biotechnology and medical investments, with focused areas in companies engaging in new drug research and development, high-end medical equipment, innovative medical service technology, medical channels, and agricultural biotechnology, etc. Diamond Biofund Inc. has incubated and invested in more than 20 entrepreneurs and companies domestically, regionally and globally.

1.2 Key Trends

The expectation is that in 2025, the venture capital markets in Taiwan will still be strongly influenced by government-supported initiatives that promote start-up and innovation. Some of these initiatives include:

- the continuing promotion of listing on the Taiwan Innovation Board (TIB) by the TWSE since July 2021, with a related relaxation of limitations/qualifications for doing so;
- TWSE's lifting of the restriction regarding qualified investors who meet certain criteria relating to trading experience and financial stability since 6 January 2025 allowing all investors to trade the stocks registered on the TIB;
- the lifting of certain restrictions on Taiwanese insurance companies' investment in private equity funds and venture capital funds; and
- new investment opportunities related to the booming of artificial intelligence and semiconductors and the growing use of sustainable energy, both domestically and internationally.

As VC investment in Taiwan continues to thrive in the midst of the global downturn, there is no significant change in deal term observed in Taiwan, while venture capitalists do tend to invest a smaller amount per deal or make investments in start-ups in installments.

1.3 Key Industries

With the relaxation by the National Development Council (NDC) of the restrictions on insurance companies' investment in onshore private equity funds and venture capital funds, especially in the infrastructure sectors, it is anticipated that Taiwanese insurance companies will invest in industries designated by the Financial Supervisory Commission (FSC), as permitted industries to be invested in by onshore private equity funds

and venture capital funds, including green and renewable energy technology, projects under the *"Asia's Silicon Valley"* programme, biotechnology and pharmaceuticals, the defence industry, smart machinery, new agriculture, circular economy industries, the information and digital industry, the cybersecurity industry, the precision health industry, and the military industry, as well as additional industries announced under the Trillion Dollar Investment National Development Plan and the Asian Asset Management Center Plan in 2024 and early 2025.

According to a StartupBlink 2024 report, the most notable industries among Taiwanese start-ups were software and data (29.7%), healthcare (18.8%) and hardware, and the internet of things (IoT) (14.4%).

2. Venture Capital Funds

2.1 Fund Structure

Venture capital funds are typically organised in the following forms.

- A company limited by shares under the Company Act:
  - (a) decision-making body – the board of directors' meeting and the shareholders' meeting (some companies will also establish an investment committee, which shall report to the board); and
  - (b) standard corporate governing documentation:
    - (i) articles of incorporation of the fund; and
    - (ii) shareholders' agreement among the shareholders.
- A limited partnership under the Limited Partnership Act:
  - (a) decision-making body – general partner and fund manager; and
  - (b) standard corporate governing documentation:
    - (i) partnership agreement among the general partner and limited partners; and
    - (ii) management agreement between the general partner, the fund and the fund manager.

2.2 Fund Economics

Venture capital funds in Taiwan generally follow global market practice in terms of fund economics. Fund Principals (initiators, managers, etc) are usually entitled to the following management fees and carried interest:

- the management fee is charged at a certain percentage, usually 1.5% to 2.5%, of the total fund managed/invested; and
- the carried interest is charged at a certain percentage, usually 20%, of the profits of the fund, subject to certain limitations in the event the fund has suffered losses, such as claw-back of the carried interest paid to the general partner in previous years to ensure that the general partner would not receive more than the agreed percentage of carried interest over the life of the fund.

2.3 Fund Regulation

In terms of corporate governance, venture capital funds are not regulated by any laws specific to them. Venture capital funds in the form of a company limited by shares are regulated by the Company Act, while venture capital funds in the form of a limited partnership are regulated by the Limited Partnership Act. Some CVCs established by financial holding companies would be subject to laws and regulations related to such companies.

2.4 Particularities

The following types of VC fund have grown to be an increasingly significant part of the Taiwan venture capital market.

Government-Backed VC Fund/Fund-of-Funds

The National Development fund (NDF), established by the National Development Council of the Executive Yuan, Taiwan's highest administrative body, is very active in investing in entrepreneurs, either directly or through other funds, in order to support finance, technology, talent cultivation and management of new ventures, and to meet the government's needs around national economic development. One notable example is NDF, which, together with several financial institutions, has established the Taiwania Capital Management Corporation (*"Taiwania"*), and has been appropriating a significant amount of funds to invest in start-ups. Taiwania has raised several funds-of-funds that focus on investment in specific industries such as the IoT, biotechnology and technology.

CVCs

Through making investments by CVCs in start-ups that are in related industries, leading companies in Taiwan efficiently acquire innovative technologies or achieve supply chain integration, especially in the technology and biotechnology sector. Large financial institutes also, through their CVCs, look for and invest in start-ups that have a potential financial upside.

Green-Energy-Related Fund

The Taiwan government aims to retire all nuclear power plants by 2025 and is actively supporting the development of renewable energy sources such as offshore wind farms, solar power and other green energy alternatives. Several financial institutions have formed their own venture capital funds with a focus on green energy, and these funds, together with banks in Taiwan, have played important roles in financing transactions in the renewable energy industry in Taiwan.

3. Investments in Venture Capital Portfolio Companies

3.1 Due Diligence

For early stage and/or small-scale investment, most VC funds would usually only conduct high-level financial, legal and business due diligence in-house rather than engaging external advisers. VC funds usually focus on business and technology due diligence, including the technology to be developed, business model and plan. Legal due diligence is usually not the main focus but the VCs would still pay attention to the agreements with existing shareholders, restrictions on the founders, IP issues, material business contracts and major legal proceedings.

For mid-stage or large-scale investment, most VC funds, the lead investor, would engage external legal counsel to conduct a more comprehensive legal due diligence that covers most aspects of the target company's operation, including the following:

- corporate and permit;
- shareholders' agreements;
- material contracts with top ten (or major) suppliers and customers;
- major assets;
- arrangements with founders and employees, including employee stock ownership plan (ESOP) or other incentive structure;
- compliance;
- IP matters;
- customary public search, including IP and litigation searches; and

- other industry-specific areas such as data protection policies for companies that collect and process user data to provide data-driven, personalised healthcare management services.

The focus of VC funds' legal due diligence is the following:

- identify pre-emptive rights, warrants or any other right to subscribe/convert into equity of the company that would result in the dilution of the VC funds' investment;
- identify any preferential right of existing shareholders, such as dividend preference, voting arrangement, etc;
- identify related-party transactions, especially outstanding shareholder loans;
- confirm whether proper proprietary rights arrangements, non-disclosure and non-compete arrangements are in place with the founders and key-employees, especially for technology-based companies;
- identify irregularities in the material contracts;
- identify non-compliance that would expose the target company to material risks; and
- identify industry-specific risks such as personal data protection risks.

3.2 Process

The time required for new anchor investors and a growth company to initiate the next round of financing depends on the industry that the target company is in and the life cycle of the product/service of the target company. It could take six months to a year to complete one round of financing.

In practice, after seed round financing, entrepreneurs would seek financing from institutional investors, including venture capital funds. A proper shareholders' agreement in a customary form would be in place when VCs invest. In a single round of financing, for cost-efficiency purposes, the anchor investor will usually engage legal counsel, on behalf of all co-investors, to conduct legal due diligence and to draft/review the transaction documents.

3.3 Investment Structure

The commonly seen investment approach by VC funds in Taiwan is the subscription of preferred shares with preference rights that common shares do not have. Due to the relatively strict regulations of the Company Act, many foreign VC funds prefer that start-ups adopt an *"offshore holding structure"*. This involves establishing a holding vehicle in locations such as the Cayman Islands, British Virgin Islands, Singapore or elsewhere, which holds a 100% shareholding in Taiwanese start-ups. Investing in offshore holding companies provides more flexibility in negotiating shareholders' agreements, and foreign VC funds (other than PRC investors as defined under Taiwan law) need not obtain prior foreign investment approval from the Department of Investment Review (DIR) of the Ministry of Economic Affairs, previously known as the Investment Commission.

The customary preference rights of preferred shares in the Taiwan venture capital market include the following:

- information and inspection right;
- guaranteed board seat or board observer seat;
- pre-emptive right, which allows preferred shareholders to participate in the company's new rounds of security offerings on a pro rata basis;
- anti-dilution protection, which entails adjustment to applicable conversion price for the conversion of preferred shares into common

shares upon the occurrence of an event that would dilute the shareholding/value of the preferred shares, such as the target company's issuance of additional securities at a price lower than the preferred shareholders' original subscription price;
- board reserved matters, for which the consent of a certain number of directors must be obtained before the company can execute such matters;
- preferred shareholders' reserved matters, for which the consent of a certain percentage of the preferred shareholders must be obtained before the company can execute such matters;
- right of first refusal, which gives preferred shareholders and/or founders the priority right to purchase shares that are offered to be sold by other shareholders on a pro rata basis;
- right of co-sale/tag-along, which allows preferred shareholders to sell the preferred shares together with the shares offered to be sold by other shareholders, usually the major common shareholders/founders/key employees; and
- liquidation preference, which gives the preferred shareholders the right to be paid before the common shareholders, typically 100–200% of the preferred shareholders' original subscription price, upon the target company's liquidation.

The redemption right may be negotiated on a case-by-case basis, while the valuation adjustment mechanism is not commonly used in Taiwan venture capital investment.

3.4 Documentation

The typical key documents for a financing in a growth company are a share subscription agreement, a shareholders' agreement and the amended constitutional documents of the target company reflecting the investment terms.

For international VC funds or for investments in the offshore holding entity of a Taiwan-based company, the commonly used forms are the Cayman Islands or the British Virgin Islands model forms. For local VC funds' or CVCs' investments in a locally incorporated entity, it is common that investors and the target company would prefer using a relatively concise form of investment agreement that is comprised of the provisions relating to share subscription and shareholder rights.

3.5 Investor Safeguards

The preferred shares subscribed by the VC investors are usually attached to the liquidation preference right that allows the preferred shareholders to be paid, typically between 100%–200% of the subscription price they originally paid, before the common shareholders, during the target company's liquidation process or deemed liquidation events.

Preferred shares conversion mechanisms and anti-dilution provisions are popular provisions to protect VC investors' rights. An anti-dilution provision is an adjustment to applicable conversion price for the conversion of preferred shares into common shares when the target company issues new shares at a price lower than the preferred shareholders' original subscription price. Under the Company Act, existing shareholders are entitled to the mandatory pre-emption right over new shares; nevertheless, it is still common for transaction documents to stipulate the investor's pre-emption right over new shares.

These safeguard mechanisms have been quite standard for VC investment in Taiwan and there

has not been any significant change to these mechanisms recently.

3.6 Corporate Governance

Venture capital investors typically have certain rights over the management of the target company, including information and inspection rights, a guaranteed board seat or board observer seat, and the ability to participate in or control the company's decision-making process in relation to the board and shareholders' reserved matters. These reserved matters typically pertain to key issues that could significantly impact the business or operation of the company, such as:

- amending the constitutional documents;
- financing;
- implementing an ESOP;
- engaging in mergers and acquisitions;
- dissolution and liquidation; and
- entering into key licensing agreements.

Additionally, certain matters are reserved for the board or shareholders' vote for governance purposes, such as related-party transactions or agreements with founders or key employees.

3.7 Contractual Protection

A target company's and its major shareholders' standard representations and warranties generally relate to the following:

- valid incorporation and existence and capitalisation of the company;
- completing/obtaining necessary corporation actions/government or third-party consents;
- no breach of legal or contractual obligation/no termination of material contracts;
- full disclosure of financial information;
- no material legal proceedings;
- ownership of or right to use all IP rights and assets necessary for the business operation;
- entry into of necessary proprietary rights/non-disclosure/non-compete agreements;
- compliance in all material aspects; and
- full and accurate disclosure of information material to the investors' investment.

A target company and its major shareholders shall adhere to a set of standard and crucial covenants and undertakings from the execution of the transaction documents until the closing of the transaction. These obligations include refraining from taking major actions, such as borrowing money, disposing of material assets, ceasing any existing business, or taking any actions that are out of the company's ordinary course of business. In addition, they shall take all measures to fulfil the conditions of the transactions and to ensure their representations and warranties remain true and correct up to the closing.

4. Government Inducements

4.1 Subsidy Programmes

The most prominent project is the Business Angel Investment Programme launched by the NDF with an aim to establish a sound start-up investment mechanism to improve the angel investment environment in Taiwan.

The details of the Business Angel Investment Programme are as follows.

- Its term runs from May 2018 to 31 December 2025.
- The total amount of funds allocated to the programme is TWD5 billion (around USD167 million).
- The investment is structured as a subscription of equity in eligible start-ups by the NDF,

together with angel investors and domestic and foreign institute investors.
- Eligible start-ups include:
  (a) start-ups registered in Taiwan or overseas start-ups whose main business operations are in Taiwan;
  (b) those established for less than five years;
  (c) those with a paid-in-capital or fundraising size of less than TWD100 million (around USD3 million); and
  (d) with the consent of the NDF's investment review committee, start-ups which do not meet the above restrictions.
- The NDF has the following investment caps:
  (a) its fundraising per start-up shall not exceed TWD20 million (around USD670,000), which can be increased to TWD30 million (around USD1 million) if the start-up meets certain requirements;
  (b) its total investment per start-up shall not exceed TWD100 million (around USD3 million); and
  (c) its and other state-owned entities' accumulative shareholding in one start-up shall not exceed 50%.

As of the end of 2024, the NDF Business Angel Investment Programme had invested in 277 start-ups with an accumulated investment amount of TWD3.92 billion from the NDF and TWD14.83 billion from other co-investors. It is reported that the NDF might appropriate an additional TWD5 billion (around USD167 million) to this programme to incentivise investment in Taiwan-originated start-ups.

4.2 Tax Treatment

The Statute of Industry Innovation provides incentives to individuals investing in start-up companies, as well as creators in academic and research institutions as below.

Tax Incentives for Individual Angel Investors

Individuals who invest a total of TWD1 million in cash in a year in a designated high-risk start-up company that has been established for less than two years can deduct up to 50% of their investment amount from their annual taxable income. The maximum annual deduction amount allowed is TWD3 million.

Deferred Tax for Stock Issued to Creators

Creators (such as academics or researchers) who receive stock from academic and research institutions can hold the stocks until the time of transfer, at which point they will be taxed based on the transfer price or market price of the stocks when they received the stocks if the transfer price is higher, so as to promote the industrialisation of research results.

In addition, according to the Limited Partnership Act, the Statute for Industrial Innovation and the interpretation of the Ministry of Finance, venture capital businesses established under the Limited Partnership Act (ie, in the form of a limited partnership, rather than in the form of a corporation) may qualify for *"pass-through taxation"* if they meet certain conditions. For example, where the total contributed funds of the limited partnership reach TWD300 million with 50% of the funds being invested in Taiwanese companies or offshore companies whose main business operations are in Taiwan, and 30% of the actual investment is invested in new start-up companies, or the aggregate actual investment amount reaches TWD300 million (whichever is lower). This means that the venture capital business itself is not subject to business income tax, and the capital gains are only taxed as income tax when distributed to the limited partners. This helps to reduce the disparity in tax treatment between venture capital funds in the form

of limited partnerships and those in the form of corporations.

However, please note that, pass-through taxation for limited partnerships in Taiwan applies a different tax treatment based on the source of income, which differs from pass-through taxation as commonly seen in other jurisdictions.

4.3 Government Endorsement

In 2021, the TWSE launched the TIB and the Taipei Stock Exchange (TPEX) launched the Pioneer Stock Board (PSB) under the Emerging Stock Market (ESM), a separate new board in addition to the Emerging Stock Board (ESB) exclusively for qualified investors at that time, aiming to facilitate fundraising by innovative businesses in the capital markets.

Start-ups in the designated core and strategic industries, or in designated innovative industries, could be registered and publicly traded on the PSB without meeting certain requirements as to existence, profitability and dispersed shareholding. In addition, the underwriters and the TPEX provided more assistance to – and supervision over – the start-ups registered on the PSB to address the start-ups' lack of capital market experience, while only allowing qualified investors to trade shares in companies registered on the PSB. However, as from 1 January 2024, the PSB ceased to exist, and the companies registered on the PSB and ESB were integrated into a single market under the ESM. In response to this change, since 1 January 2024, companies applying to register on the ESM have been able to choose to adopt either a standard public issuance or a simplified public issuance procedure, and the ESM has become open to all investors.

Before 6 January 2025, stocks registered on the TIB could be traded only by qualified investors that meet one of the following criteria:

- a professional institutional investor or a juristic person with one or more years of experience in securities trading/investment;
- a legally incorporated venture capital enterprise;
- a juristic person with IPO shares at TIB through negotiated sales; and
- a natural person with two or more years of experience in securities investment, who has:
  (a) proof of TWD2 million or more on their financial statements; or
  (b) an average annual income of TWD1 million or more over the last two fiscal years.

In order to allow more fund accessibility for start-ups, TWSE lifted the restriction regarding qualified investors, which allows all investors to trade stocks registered on the TIB starting from 6 January 2025. According to a TWSE news release dated 19 February 2025, the trading volume of TIB for the period from 6 January to 14 February 2025 already exceeds 30% of the annual trading volume of 2024 and the daily trading volume has increased 253% as compared to 2024, which clearly evidences that this change in policy has significantly increased the level of interest in the TIB from the market.

5. Employment Incentives

5.1 General

VC investors would usually require founders/key employees to commit to working full time for the target company during their mandate/employment with the company. To incentivise the founders/key employees not to terminate their mandate/employment early, which they are

entitled to do, a stock option plan and necessary transfer restrictions may also be adopted.

5.2 Securities

Statutory employee stocks with transfer restrictions (*"employee-restricted stocks"*) as stipulated under the Company Act or employee stock options are commonly used to incentivise founders and employees.

Employee-restricted stocks, as stipulated under the Company Act, may be issued to employees first while being subject to transfer restriction of no more than two years. Employees will be able to freely transfer the shares after meeting the applicable requirements and upon the expiration of the restrictive period.

Employee stock options are usually vested by instalment over time with a vesting period of two to four years and/or when founders/employees meet certain other performance requirements. Upon the vesting of options, employees may determine whether to exercise the options and subscribe for the shares in the company.

5.3 Taxation of Instruments

There is different tax treatment of employees in respect of (i) employee stock options and (ii) employee-restricted stock offered by a Taiwanese company to its employees in Taiwan or offered by a foreign company to the employees of its Taiwan branches/Taiwan subsidiaries. However, given that the relevant taxes arising from the exercise of employee stock options or the disposal of employee-restricted stock and the subsequent sale of the shares acquired are to be borne by the employees, this tax consideration would not generally affect the company's determination of the structure of the incentive pool.

5.4 Implementation

Given that an option pool would potentially dilute the investors' investment, VC investors usually agree to reserve a fixed percentage of the total issued and outstanding shares of the company, either pre or post the closing of a fundraising round, for the employee option pool. Further, the adoption of any additional option plan would be included in the list of board or shareholder-reserved matters to ensure that the investors have control over, or at least will be made aware of, any proposed new option plan.

6. Exits

6.1 Investor Exit Rights

VC investors typically request the following rights in the shareholders' agreement in relation to a trade sale or IPO of a target company or other liquidity event.

- Inclusion of sale or IPO of the target company in the list of board and/or shareholder-reserved matters so that the VC investors have control over, or will be made aware of, the proposed sale or IPO of the company/other liquidity event.
- Registration right – this provision is commonly observed when the target company adopts an *"offshore holding structure"* with the intention of going public in jurisdictions outside of Taiwan (if the target company is incorporated in Taiwan with the goal of going public in Taiwan, this is not necessary because all the issued and outstanding common shares of a company would be listed together).
- Drag-along right – where shareholders holding the majority or a certain number of shares may demand minority shareholder support, vote in favour of and participate in a proposed sale of the shares or assets of the

company to facilitate the completion of the proposed sale.
- Liquidation preference in the event of a trade sale, liquidation or other event that constitutes a deemed liquidation event. *"Exit"* is typically defined as an IPO, dissolution, winding up or liquidation. *"deemed liquidation"* event includes a merger and acquisition; the sale of all or substantially all the assets of the company; or any merger or acquisition of the subsidiary or affiliate of the company, whereby the target loses majority control of such subsidiary/affiliate after the closing. Despite the rarity of the occurrence of liquidity events, there has not been any significant change in the exit mechanisms.

It is not common to stipulate transfer restrictions to VC funds in a shareholders' agreement, other than right of first refusal or drag-along right as discussed above.

6.2 IPO Exits

According to a survey from the Small and Medium Enterprise and Start-Up Administration (part of the Ministry of Economic Affairs), out of a total of approximately 636,648 newly established companies over 2017–22, only around 2,000 have successfully raised funds from VC investors, and only 155 companies publicly listed on Taiwan's stock market during the same period, which entails a successful rate of only 0.24% from start-ups to IPOs. Even if a few offshore listing precedents are taken into account (including Gogoro's and Gorilla Technology's listing on NASDAQ, Perfect Corp.'s listing on the NYSE, Gorilla Technology, Semilux International Ltd., TNL Mediagene and FST Corp.'s listing on the NASDAQ, Appier's listing in Japan, and 17Live's listing in Singapore), the success rate for Taiwanese start-ups reaching an IPO in recent years is still low.

The choice of listing venue depends on the product of/market for the relevant start-up. The support of shareholders and strength of different stock exchange are all important elements to be considered. Take Appier's listing in Japan, for example; according to the local news, the key management of Appier advised that Japan has always been a key market for Appier, and given the shareholder relationships with SoftBank and LINE, choosing to list in Japan would greatly benefit Appier's continued expansion in Japan. They also considered the software industry in Japan, capital structure and start-up scale, the activeness of foreign capital, and the advice of investors. Appier chose to list on the suitably growth-oriented Tokyo Stock Exchange Mothers Market.

On the other hand, the TWSE's efforts to promoting domestic listing by Taiwan start-ups are noteworthy. Since the launch of the TIB until the end of 2024, 30 companies have applied to be registered on the TIB, covering industries such as digital cloud, green energy and environmental protection, biotechnology and medical care, and electric vehicles. Out of those 30 companies, 20 have successfully been registered and publicly traded on the TIB with a total annual turnover of TWD24.96 billion in 2024. The price-to-book ratio of the stocks registered on the TIB is 4.47 as of the end of February 2025, which is significantly higher than the price-to-book ratio of the stocks listed on the main board of the TWSE; ie, 2.46. This shows the market is optimistic about the prospects of the start-ups registered on the TIB. This continuous growth is driving the formation of new economic industry clusters, using an *"innovation-driven"* economic growth model to help companies expand into international markets, strengthen operational resilience, demonstrate innovative capabilities, and ultimately elevate Taiwan's position in the global innovation economy. Another good example of the out-

come of TWSE's efforts is that an LED company registered on the TIB has been included in Morgan Stanley Capital International (MSIC)'s World Small Cap Index since February 2025.

6.3 Pre-IPO Liquidity

Given the low success rate for start-ups reaching an IPO, VC investors in Taiwan find it challenging to achieve timely exits with reasonable returns before IPOs.

One key feature of the TIB is its ability to facilitate secondary market trading of start-ups. Before 6 January 2025, only qualified investors are permitted to participate in the trading of stocks listed on the TIB, but the lifting of the restriction on qualified investors that allows all investors to trade stocks registered on the TIB has successfully expanded the secondary market with a significant increase in the trading volume on the TIB in the first month after implementing such change (see **4.3 Government Endorsement** for details of the change in law relating to investor qualifications).

7. Regulation

7.1 Securities Offerings

If a venture capital transaction involves any *"US elements"*, such as the target group having business operations in the United States, or the potential investors being US citizens or companies, it is common to include the typical *"disclaimer"* of foreign securities offering under the US Securities Act. However, this is not a requirement under Taiwan law.

There are no specific offering provisions required by Taiwan law. However, in practice, some companies may request investors to acknowledge that they are accredited or sophisticated investors and understand the high risk of investing in start-ups.

In a venture capital transaction where there are multiple minority investors or a significant number of existing minority shareholders, the shareholders' agreement would be signed by major shareholders meeting a certain threshold that is sufficient to pass necessary board and shareholder resolutions.

7.2 Restrictions

Foreign investors (other than PRC investors) (i) must obtain prior foreign investment approval from the DIR before investing in the equity of Taiwanese companies, and (ii) are prohibited from investing in Taiwanese companies that engage in certain businesses listed on a negative list. Some industries may have foreign shareholding limitations.

PRC investors as defined under Taiwanese laws (i) may only invest in Taiwanese companies engaged in the businesses listed on a positive list for sectors permitted to be invested in by PRC investors, and (ii) must obtain prior foreign investment approval from the DIR before investing in the equity of Taiwanese companies (that only engage in the businesses as described under (i) above). It is important to note that any company with 30% or more shareholding held directly or indirectly by PRC citizens/companies, or controlled directly or indirectly by PRC citizens/companies, would be considered *"PRC investors"* and be subject to PRC investment restrictions. Funding from military or political sources in the PRC is prohibited. However, in practice, any application for PRC equity investment in Taiwan would be subject to stringent scrutiny.

Apart from the reorganisation of the DIR, there have been no significant changes in the past 12 months regarding the restrictions governing foreign/PRC investments in Taiwan, particularly in terms of venture capital investment.

Trends and Developments

Contributed by:
Lihuei Mao (Grace), Dennis Yu and Christina Chiang
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Lee and Li, Attorneys-at-Law is a leading full-service law firm with specialisations which include banking and finance, capital markets, corporate and investment, litigation and dispute resolution, patents and technology, and trade marks and copyrights. The firm regularly advises venture capital, private equity, and institutional investors on a wide range of industries in Taiwan, including AI, fintech, cryptocurrencies, AIoT, SaaS, e-commerce, biotechnology and digital health. Apart from supporting the formation of reputable local venture capital funds such as Taiwania and JAFCO, Lee and Li provides assistance to Taiwanese venture capitalists in their start-up investments, including Taiwania, CDIB, JAFCO, WI Harper, and others. It also actively assists entrepreneurs with financing and IPO planning. In recent years, the firm has participated in several *"de-SPAC transactions"*, which enable Taiwan companies to be listed on US stock exchanges. Some of the companies the firm has helped list include Perfect Corp. (NYSE), Gorilla Technology (NASDAQ), Semilux International Ltd. (NASDAQ), TNL Mediagene (NASDAQ) and FST Corp. (NASDAQ).

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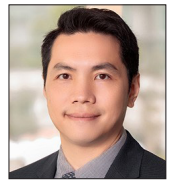

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In 2025, it is expected that the venture capital markets in Taiwan will remain heavily driven by the momentum generated by the government's initiatives to promote start-ups and innovation, as well as the new investment and business opportunities motivated by the government's policy to encourage and develop sustainable energy.

The launch of the Taiwan Innovation Board (TIB) by the Taiwan Stock Exchange (TWSE) in July 2021 and the Continuing Reform in 2025

TWSE's launch of TIB for clustering innovative listings is a major milestone that aims to create more fundraising opportunities for innovative businesses in the capital market. Under the rules of the TIB, start-ups in designated core and strategic industries or innovative industries can be exempted from certain mandatory listing prerequisites for the main board. During the first few years after the launch, stocks registered on the TIB can only by traded by qualified investors who meet certain criteria relating to trading experience and financial stability, but the TWSE lifted such restriction regarding qualified investors and allows all investors to trade stocks registered on the TIB starting from 6 January 2025 in order to promote fund accessibility for companies registered on the TIB.

The registration requirements of the TIB are more flexible than those of the main board and are more start-up-oriented, for example:

- companies meeting all other requirements can apply for listing on the TIB two years after incorporation (as compared to the three-year requirement of the main board), which expedites the time for start-ups to gain funds from the capital market; and
- considering innovative start-ups, especially in the energy and biotechnology sectors, take longer to become profitable, a start-up may be eligible to apply for listing on the TIB while operating at a loss, as long as its valuation and working capital meet certain requirements (as compared to the profit requirements of the main board).

Since the launch of the TIB until the end of 2024, 30 companies have applied to be registered on the TIB. Out of those, 20 have successfully been registered and publicly traded with a total annual turnover of TWD24.96 billion in 2024.

The Emergence of Green Energy-Focused VCs Under the Global Surge of Renewable Energy

The Taiwan government aims to retire all nuclear power plants by 2025 and has taken steps to support the development of renewable energy. Reports show that the average annual growth rate of renewable energy power generation from 2019 to 2023 reached 14%, which is higher than the global average. In 2024, renewable energy power accounted for 11.6% of the total power generated in Taiwan, which reached a historical high.

This increasing demand for renewable energy has led to various business opportunities throughout the green energy supply chain. Many financial institutions have formed their own venture capital funds that focus on green energy-related business, including start-ups.

In 2023, Grinnodot, the parent company of Sunnyfounder, a renewable energy-based electricity retailer, together with Cathay Securities, issued the first Security Token Offering (STO) in Taiwan, Sunshine Green Benefit Debt STO. This was made possible due to the enactment of a special law on STO that enables Grinnodot and Sunnyfounder to reach a wider pool of potential qualified investors in the capital market. STO is a

relatively more cost-efficient fundraising mechanism compared to traditional approaches.

Energy-related venture capital funds, together with financial institutions and alternative fundraising platforms, play important roles in financing transactions in the renewable energy industry in Taiwan.

Expectations on Capital From Insurance Companies to Private Equity Funds, With NDC's Review

With the aim to utilise the large insurance proceeds controlled by Taiwan insurance companies to invest in strategic industries via onshore private investment funds while ensuring the sound financial condition of insurance companies, the National Development Council (NDC) enacted the NDC Directives on Guiding and Managing the Promotion of Industrial Investments by Private Equity Funds in June 2021. Under the Directives, onshore private equity funds that meet the statutory requirements, such as having assets under management amounting to TWD1 billion or more, and aiming to invest in emerging and key strategic industries announced by the Financial Supervisory Commission (FSC), may apply with the NDC for review and qualification. The NDC will then grant a qualification letter to the onshore private investment fund if it meets the necessary criteria.

In other words, a qualified onshore private investment fund approved by the NDC will be permitted to solicit and receive investments from Taiwanese insurance companies; however, a qualified onshore private investment fund that receives funds from Taiwanese insurance companies will be subject to stringent regulations.

On 28 January 2022, the FSC issued a ruling stating that if a qualified onshore private investment fund is approved by the NDC to deploy 50% or more of its investment in foreign jurisdictions, the money received by such fund from Taiwanese insurance companies can be used to invest in foreign companies. This ruling paved the way for onshore private investment funds to invest in foreign companies by using the capital contributed by Taiwanese insurance companies. It also enables Taiwanese insurance companies to indirectly invest in foreign companies through qualified onshore private investment funds.

In addition, in December 2023, the FSC reduced the risk coefficient of onshore private equity funds and onshore venture capital funds that invest 100% of its capital in infrastructure projects from 33.75% to 10.18%. Furthermore, as a part of the government's Trillion Dollar Investment National Development Plan and the Asian Asset Management Center Plan launched by the Taiwan government, the FSC announced in September 2024 to further reduce the risk coefficient of onshore private equity funds that invest 100% of its capital in infrastructure projects from 10.18% to 1.28% for the entire investment period, and also further relaxed certain other investment restrictions in early 2025. These measures incentivise Taiwanese insurance companies to invest more in local infrastructure project-based onshore venture capital funds.

Given all the above, it is expected that onshore PE/VC funds would have more opportunities to solicit funds from Taiwanese insurance companies.

Furthermore, the following developments in the Taiwan market are also noteworthy.

Scrutiny on PRC Investment Into Taiwan and Other Mechanisms to Prohibit Illegal PRC Investment in Taiwan

Besides continuing scrutiny on applications from PRC investors to invest in Taiwan, several law amendments were enacted to strengthen

the enforcement and prohibition on illegal PRC investment into Taiwan, including the following.

Penalties for investing in Taiwan via Taiwanese nominees

To prevent PRC investors from using nominees to invest in Taiwan and thereby bypassing the PRC investment approval process, the Act Governing Relations between the People of the Taiwan Area and the Mainland Area (the *"PRC Relations Act"*) was amended to prohibit Taiwanese individuals from offering their names to, or allowing the use thereof by, PRC investors for the purpose of investing in Taiwan. In case of violation of the above requirements, both the PRC investor and the Taiwanese nominee would incur a fine ranging from TWD120,000 to TWD25 million, which can be imposed consecutively until rectification. In addition, the Department of Investment Review (the competent authority in charge of reviewing PRC investment applications) may order the violator to cease or withdraw such investment or to rectify it within a specified time, and may suspend the violator's shareholder rights, and even instruct the company registration authority to revoke or nullify the violator's company registration.

Increased penalties for engaging in business activities in Taiwan

The PRC Relations Act was further amended to increase the criminal liabilities for PRC profit-seeking enterprises that engage in business activities in Taiwan by using non-PRC intermediates or Taiwanese nominees. Under the amended Article 93-2, a violator will be subject to imprisonment for up to three years (compared to one year before amendment), detention and/or a fine of up to TWD15 million (which was TWD150,000 before amendment).

Punishments for Theft of Taiwanese Core Technologies

The National Security Act (NSA) was amended on 8 June 2022, to raise criminal liabilities for the theft of Taiwanese core technologies, in response to several incidents where the trade secrets of Taiwan's hi-tech companies were stolen by PRC competitors.

The amendment states that any individual who engages in any act that infringes upon the trade secrets of any national core critical technology (such as stealing Taiwan's critical technologies) with a certain motive as defined under the NSA will be deemed to have committed an Economic Espionage Crime and face a maximum of 12 years in prison and a fine of between TWD5 million and TWD100 million. The definition of *"national core critical technologies"* will be reviewed regularly by the National Science and Technology Council (NSTC) and be submitted to the Legislative Yuan for recordation. On 5 December 2023, the first tranche of national core critical technologies, totalling 22 items, and the competent authority in charge thereof, were announced. These items cover technical fields with leading advantages and requiring urgent protection; for example, defence technology, space, agriculture, semiconductors and information security.

Increased Protection Over High-Tech Industries

The PRC Relations Act was also amended to impose additional restrictions on professionals who have access to trade secrets. For example, if an individual or member has engaged (or had engaged within the past three years) in critical technologies-related research projects funded by government agencies (authorities), they must submit a prior application and obtain an approval before entering Mainland China.

UK

Law and Practice

Contributed by:
Dylan Doran Kennett, Michael Jacobs, Stephen Newby and Mark Ife
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Herbert Smith Freehills LLP offers a global venture capital and growth equity practice with a deep bench of specialist practitioners across the world, including in the UK, Germany, France, Spain, Italy, Singapore, Australia, South Africa, the US, UAE and Saudi Arabia. The UK team consists of 20 dedicated lawyers who cover all aspects of venture capital and growth equity, across multiple sectors. The firm emphasises a blended practice across early-stage and late-stage transactions, acting for companies, institutional investors and corporate venturing houses alike, and across the entire life cycle from seed to exit, including IPOs. It has extensive sector capabilities and established practices, acting for scale-up companies, particularly in the tech, fintech, cleantech, life sciences, media and sport and consumer sectors. This material was researched and written by Dylan Doran Kennett, Michael Jacobs, Stephen Newby, Mark Ife, Veronica Roberts, Casey Dalton, Zoe Wilson, Jhanelle Bisasor, Evan Li, Emily Travers, Theo Pickles and Mohamed Sabry Salama.

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1. Trends

1.1 VC Market

Financings

Of the publicly disclosed transactions, one of the largest UK venture financings over the past 12 months occurred in May 2024, with London-based autonomous vehicle technology company Wayve securing a substantial GBP840 million investment in its Series C investment round led by SoftBank, with contributions from NVIDIA and Microsoft. Other notable financing rounds in the UK included the following.

- In May 2024, London-based fintech lending service Abound secured funding that in aggregate could extend up to GBP800 million in a mixture of equity and debt finance. The financing encompasses a multi-year asset-backed debt arrangement facilitated by long-time supporter Citi, with the Series B equity portion being led by Silicon Valley-based GSR Ventures.
- London-based challenger bank Monzo also secured funding in May 2024, which in aggregate could extend up to GBP497 million in a mixture of equity and debt finance. The initial round was led by CapitalG, a fund owned by Alphabet, while the top-up round was led by Hedosophia (an early backer of Wise and Uber) and Singapore's Government Investment Corporation.

Exits

In May 2024, Pango completed its GBP138.6 million acquisition of Gett, the mobility tech player, marking the largest exit in UK venture capital for the first half of 2024. Gett had previously fallen out of unicorn status and saw its lower valuation create acquisition opportunities, a trend often observed during periods of valuation rationalisation. Gett's shareholders included VNV Global, Access Industries and MCI Capital.

June 2024 saw the IPO of British single-board computer manufacturer Raspberry Pi on the London Stock Exchange, valuing the company at approximately GBP540 million at the time of listing. Raspberry Pi's investors included British semiconductor and software manufacturer Arm and Sony's semiconductor unit.

The latter half of 2024 also saw significant exits in the life sciences and AI sectors, with pharmaceutical behemoth Merck completing its acquisition of UK-based ophthalmology biotech company Eyebiotech Limited (EyeBio) for approximately USD3 billion in July 2024. The largest AI exit was the EUR1.7 billion reverse merger of UK-based ecommerce and sales AI-enabled solutions provider Rezolve Ai with Armada Acquisition Corp, seeing Rezolve debut on the Nasdaq in August 2024.

1.2 Key Trends

Much like in the US, the UK's current economic climate has forced the VC market to shift from a strategy of *"growth at all costs"* to one where companies need to show strong positive unit economics and a pathway to profitability if they are to remain attractive for funding. Company valuations have started to align more with their public market comparables but, broadly, there may still be a delta in the *"bid/ask"* spread in relation to valuation, with investors not necessarily willing to subscribe at valuations that founders and management are proposing. Where there is a large difference between valuation expectations, this can be bridged on terms such as the liquidation preference multiple, anti-dilution or subscription rights in a warrant or convertible instrument to grant preferential equity rights.

More mature companies with robust business plans and management teams that forecast long-term sustainable growth and profitability are being prioritised. Investors continue to take a more focused yet cautious approach to valuations, emphasising the importance of commercial and legal due diligence. This was perhaps less of a concern in the heady days of 2021, given the amount of capital being deployed into *"hot"* deals back then.

Equity market volatility and lower PE buyout volumes also mean that conventional VC exit opportunities are currently less numerous. However, equity conditions do appear more promising as macro-economic conditions stabilise, with the IPO market, both globally and in the UK, moving past its inflection point in 2024 after hitting record lows in 2023, showing signs of recovery and growth in 2025 and beyond.

Consequently, UK businesses are having to look for other avenues to raise more money, often resulting in a higher degree of share capital structuring. For example, *"down rounds"* (when a company offers additional shares for sale at a lower price than the previous financing round) continue to occur despite the broad, overall improvement in VC terms as exit opportunities remain constrained and companies continue to need to tap the fundraising market for capital, which can crystallise lower valuations. Down rounds usually trigger anti-dilution provisions to protect investors by ensuring that they can maintain their ownership percentages through a bonus issue of shares or adjustment to the conversion ratio of preference shares to ordinary shares (the latter being more common in the US).

Increasingly, *"pay to play"* provisions are being introduced into company constitutional documents to ensure future commitment to capital-raising by existing investors. If current investors do not provide new cash for a next round of financing, their shares can be consolidated at a specific ratio while being converted into ordinary shares, leading to a potentially significant drop in their value.

General restructuring or *"flattening"* of the cap table has been a common theme in rescue financing for companies that have been unable to raise further funds in turbulent times; this often forces a complete rethink and overhaul of the cap table to save the company and ensure that new funds are secured. Convertible instruments (such as convertible loan notes and similar forms of structure) remain popular to avoid crystallising a down round and delaying valuation discussions until the markets return to a healthier state for capital raising, although they can be on onerous commercial terms and include a penny warrant style upside for the loan provider.

ESG remains a priority for investors, which are demanding due diligence across the ESG landscape. Ventures that demonstrate a commitment to ESG principles are likely to attract greater interest from socially conscious investors and to gain an edge in fundraising. Notably, in February 2025, the British Venture Capital Association (BVCA) revised its form documents for early-stage venture capital investments, which include provisions to ensure compliance by high-growth companies with a number of ESG concerns (see **3.4 Documentation**). These updates reflect the BVCA's ongoing efforts to ensure compliance with ESG concerns and other regulatory requirements, making the documents more robust and adaptable to current investment practices. This is a welcome development and ensures that venture funds are imposing their limited partners' requirements onto their portfolio companies.

1.3 Key Industries

Artificial intelligence (AI), fintech, and life sciences and biotech continue to dominate the VC landscape in the UK. According to HSBC Innovation Banking, fintech and life sciences were the most popular start-up segments in 2024, with 24% (USD3.9 billion) of UK VC investment going into fintech businesses and 20% (USD3.3 billion) invested in life sciences ventures. The UK also retained its substantial lead in Europe as the top spot for biotech investment, receiving GBP3.5 billion, representing a 94% increase compared to the previous year and the highest annual figure since the record-breaking year of 2021 (according to a report by UK BioIndustry Association).

UK university spin-outs in the life sciences sector continue to thrive, making up the highest proportion of university spin-outs in 2024. In addition, the number of AI spin-outs is rising rapidly, consistent with broader venture capital markets trends. The UK's relative strength in this area shows no signs of waning. The Oxford-Cambridge Arc, a railway line linking Oxford and Cambridge, is anticipated to foster further innovation and university spin-offs, thereby promoting sustained economic growth and attracting investment.

Given the increasing concern for climate change and pressure on governments to set and achieve net zero targets, the top funded climate tech areas were electric mobility, EV battery and autonomous mobility, according to PwC research. This includes capex-heavy companies focused on the energy transition. Beyond autonomous mobility, AI ventures offering generative AI solutions were most attractive due to the growing interest from corporates in implementing this type of AI into business practice to streamline content creation and enhance efficiency.

2. Venture Capital Funds

2.1 Fund Structure

Many VC funds established in typical fund domiciles (eg, the Channel Islands and Luxembourg) are marketed into the UK. VC funds in the UK are typically structured as an English limited partnership under the Limited Partnerships Act 1907, with a single general partner (usually a fund-specific special-purpose vehicle within the manager's group) and a number of investors who come in as limited partners. The general partner has unlimited liability for the debts and obligations of the partnership (although, in practice, it is likely to be a limited company special-purpose vehicle itself), whereas the liability of each limited partner is limited to the amount of its capital commitment to the partnership. The general partner is responsible for the day-to-day management of the fund, which is usually delegated to an appropriately authorised investment management entity within the manager's group. Limited partners often play a role in overseeing manager conflicts of interest, the replacement of key persons and other material decisions relating to the fund, either through a limited partner advisory committee or by a vote amongst all the investors.

Fund documentation typically consists of a limited partnership agreement setting out the terms of the fund, supplemented by a subscription agreement to be executed by each investor and subject to additional terms agreed bilaterally in a side letter between the general partner and any investor who negotiates such terms. A manager will also generally issue a private placement memorandum in relation to the fund, summarising the key terms of the fund and containing other marketing information and regulatory disclosures, including risk factors.

Most VC funds are established as private fund limited partnerships (PFLPs), which benefit from a lower administrative burden compared to other limited partnerships. A VC fund structure may also include alternative investment vehicles or parallel funds to accommodate investors with specific tax or other structuring or investment requirements.

Some VC funds in the UK take the form of publicly traded vehicles known as venture capital trusts (VCTs), which must meet a number of qualifying conditions. VCT investors (including retail) benefit from certain reliefs from UK taxation. As a result, VCTs are mainly marketed to UK investors.

2.2 Fund Economics

The principal return to VC fund principals is a share of the fund's profits, referred to as *"carried interest"* or *"carry"*, which ensures economic alignment between the manager and investors.

Carry structures vary depending on the respective bargaining positions of the manager and investors. Under the typical distribution waterfall, a manager might expect to take 20% of profits above an ~8 *"hurdle"*, also referred to as the *"preferred return"*, meaning that investors must see a return of invested capital plus 8% before the manager takes a share. In principle, the waterfall operates in the same way for VC funds as for private equity buyout funds. However, in a VC context, the hurdle may not be an internal rate of return or compound interest calculation. Rather, carry entitlement can often be contingent on achieving a multiple on invested capital (MOIC).

Carry is typically calculated on *"whole-of-fund"* rather than deal-by-deal basis. This structure often includes *"catch-up"*, whereby, once the preferred return is met, the manager receives a larger share of profits until they have caught up to a pre-agreed percentage of total profits. Less commonly, it includes *"super carry"* arrangements, whereby the manager takes a larger slice of profits if the fund meets a specified return. Although 20% carry (above the applicable hurdle) is still the baseline for VC funds, it is more common for fund principals to take super carry on a VC fund than for private equity buyout strategies.

The manager also receives a management fee (usually 1.5–2% pa of capital commitments) to cover its overheads. While management fees have generally been trending down over recent years, it is still common to see a 2% fee on a VC fund, which may be a reflection of smaller fund sizes in a VC context than for a typical private equity buyout fund.

Other key market standard terms in VC funds include:

- a provision to remove the manager for certain *"cause"* events (in which case the manager may forfeit some of its carry entitlement) and, in some cases, on notice without cause;
- the establishment of an investor advisory committee with oversight over manager conflicts of interest and other matters that could harm the investors' investment; and
- key person provisions under which the departure or insufficient availability of certain key manager personnel triggers consequences such as suspension of the investment period or, occasionally, termination of the fund, unless investors approve its continuation.

2.3 Fund Regulation

VC funds are classified as alternative investment funds, or AIFs, and are therefore subject

to the UK Alternative Investment Fund Managers Regulations 2013 (AIFMR) and associated Financial Conduct Authority (FCA) rules. The AIFMR are derived from and, since Brexit, so far remain broadly aligned with the rules under the EU AIFM Directive. However, the UK government and FCA are undertaking a process of repeal and replacement of the UK asset management regulation, so there may be deviations from the European position in coming years.

The AIFMR govern various aspects of the manager's conduct in respect of the fund, including in relation to:

- marketing, reporting and disclosures to investors;
- the appointment of a depositary; and
- ongoing operating requirements and restrictions, including on valuation, leverage and delegation.

The requirements under the AIFMR apply in a more limited way for non-UK managers than for UK managers.

VC funds themselves are neither authorised nor regulated in the UK. However, UK managers of VC funds must have appropriate FCA permissions. Non-UK managers may market UK or non-UK VC funds to professional investors in the UK if they meet certain conditions, including having appropriate co-operation arrangements in place between the FCA and the supervisory authority in the manager's jurisdiction.

VC funds structured as limited partnerships are also subject to the Limited Partnerships Act 1907, which imposes some basic duties on the partners, including the registration and notification of changes in the partnership to Companies House. Funds that are established as PFLPs are subject to fewer of these duties and, most notably, need not publicly disclose the capital commitments of limited partners. The Economic Crime and Corporate Transparency Act 2023 introduced requirements intended to increase transparency in relation to limited partnerships, with key changes including more detailed information and notification requirements to Companies House.

2.4 Particularities

London as a financial centre is a significant market for all classes of asset, including VC, and the UK more broadly is seeking to continue to position itself as a centre for tech, fintech, cleantech and innovation more generally, backed by homegrown and overseas VC investors. A significant portion of VC funding in the UK is channelled into biotech and other innovative enterprises spinning out from the UK's world-class universities, such as Oxford and Cambridge. Many London-based corporates are also now moving into the VC space through their own venture funds, adding a new set of players to the market – these may be dedicated funds in the traditional sense, or may be investing from their balance sheet.

In addition, since Brexit, the UK government has been focusing on promoting investment by UK pension funds (including local government pension schemes, in particular) in UK infrastructure and *"levelling up"* projects. To some extent, this is driving additional capital into UK VC funds, which are investing in such projects. In support of these aims, Chancellor Rachel Reeves announced a new National Wealth Fund (NWF) in July 2024, which was intended to align the UK Infrastructure Bank and British Business Bank under the NWF to invest in key industries, with the NWF seeing an injection of GBP5.8 billion in additional funding. In October 2024, the UK Infrastructure Bank was then rebranded to NWF.

The British Business Bank is a government-backed economic development bank that seeks (among other things) to stimulate growth in early-stage businesses and the UK economy more widely, and is a big investor in VC funds. At the International Investment Summit in October 2024, the British Business Bank revealed the establishment of the British Growth Partnership. This initiative seeks to promote increased pension fund investment in innovative businesses within the UK and aims to unlock several hundred million pounds of capital by the end of 2025.

The UK VC market also has a burgeoning community of impact investors with an investment mission focused not only on generating returns but also on having a positive environmental and/or social impact. Many impact strategies are focused on SMEs or start-ups that are seeking to bring an idea to market in order to effect positive societal change in their communities, which means there is often an overlap between VC and impact investments. The UK has been a significant contributor to the growth of impact strategies, including through initiatives driven by British International Investment (formerly CDC), the UK government's development finance institution.

3. Investments in Venture Capital Portfolio Companies

3.1 Due Diligence

Due diligence is an important part of the venture capital investment process and must be distinguished from due diligence in mergers and acquisitions. *"lighter-touch"* approach is generally adopted in VC, although intensity and standards do change with rapid shifts in economic conditions. It is important to remember that many ventures vying for seed and early-stage financing may not have been trading for very long, so the scrutiny of previous activity and corporate structure can be limited.

Investors will initially assess the investment opportunity's business model and conduct market analysis to understand the venture's industry, market potential, competitors and sustainable growth prospects. As a venture capital investment is quite often viewed as an investment in the founders, the management team will also be closely checked to evaluate their experience and expertise. With seed level investments, founders may often be asked to provide warranty coverage to the investors, although this practice is waning. Due to the sectors on which venture capital investment tends to be focused, the venture's intellectual property (IP) position will also typically be a key area of due diligence scrutiny.

Risk management is crucial, and involves assessing the company's legal and regulatory compliance, financial health and IP protection. Financial statements, contracts, licences, assets, policies and IP rights will be reviewed to identify potential legal risks and liabilities. Detailed IP due diligence is crucial for life sciences and technology venture companies, most of the worth of which lies in intangible assets. Depending on the sector, ESG considerations will be prevalent at all stages to address a company's adherence and commitment to ESG standards.

Disclosure is essential and complementary to the due diligence process by drawing out material information that will provide a full picture of the business. Companies that produce a detailed and thorough disclosure letter to investors, as required by the subscription agreement, will be viewed in a positive light and have higher chances of passing the due diligence checks

and receiving funding. Getting this wrong may jeopardise a transaction or put the founders and how their business is being managed under further scrutiny.

3.2 Process

The typical timeline of a new financing round for a growth company can range from a few weeks to a few months, depending on several factors, such as the structure of the deal, the efficiency of negotiations, the level of due diligence required and legal and regulatory issues. The stages of the financing round generally include:

- a preparation phase involving collaboration between the company and existing investors to prepare the term sheet and pitch the proposal to new investors;
- negotiating the term sheet and essential conditions of the investment;
- conducting due diligence on the company's founders, business model, financial statements, IP rights and legal and regulatory compliance;
- the drafting of key legal documents – subscription agreement, shareholders' agreement and articles of association – and other ancillary documents such as corporate authorities; and
- the completion of the deal involving the execution of the legal documents and the transfer of the investment funds to the company as consideration for the issuance and allotment of shares to the investor(s).

The relationship between existing and new investors will be a balancing act. A balance must be struck between protecting the interests of existing investors who may want to maintain a certain level of control of the company while preserving their economics, and satisfying the interests of new investors demanding preferential treatment. New share classes and rights will be created, inevitably diluting the equity and rights of existing investors and founders alike. With every new financing round there will be different expectations for the company's growth strategy and ultimately exit prospects, often creating a tension between investors with different expectations on exit horizons.

Usually, if the financing round involves multiple new investors, there will be a lead investor, who will take a more active role, and several minor investors, with the investor group usually sharing one counsel for efficiency. The company will have its own counsel, and existing investors may also choose to have separate counsel, to ensure their interests are represented and protected in the negotiation and document-drafting stages.

The existing shareholders' agreement will determine investor consent matters and detail specific share class rights. Generally, significant decisions such as major changes to the business model or new financing rounds with severe dilution effects and changes to company control will require approval from all existing shareholders.

3.3 Investment Structure

In the early stages of financing, ordinary shares are generally held by the founders and key employees. Ordinary shares have voting rights attached but, in a venture context, their holders are usually last in line to be paid out in a liquidity event, after creditors and preferred shareholders (preferred shareholders are usually the venture investors, sitting above the ordinary shareholders in the *"waterfall"*).

In early-stage financings, the most common methods of raising funds are through convertible loan notes (CLNs), advanced subscription agreements (ASAs) and preferred equity. The

type of method chosen will depend on the maturity of the business and the type of funding that the situation requires, among other things.

CLNs and ASAs are convertible instruments that allow investors to invest money into a company to be converted into equity at a future date, depending on its terms.

- A CLN is a debt instrument with an interest rate and maturity date upon which the CLN will either convert to equity or the company will be obliged to repay the loan and any accrued interest. CLNs provide security to investors in an insolvency situation, as convertible debt ranks ahead of shares in insolvency, so they are viewed as a safer investment than equity. CLNs will generally offer a discount for the investors upon conversion of the note, incentivising the investor for advancing the funds at a potentially riskier point in the company's trajectory.
- An ASA is a convertible equity investment similar to a Simple Agreement for Future Equity (SAFE) in the US, which has all the hallmarks of a CLN without the associated debt. This potentially allows investors to take advantage of Seed Enterprise Investment Scheme (SEIS) or Enterprise Investment Scheme (EIS) tax relief in the UK (see **4.1 Subsidy Programmes**), provided the characteristics of the ASA meet the HMRC guidelines and the company is eligible for such relief. ASAs will typically be triggered to apply subscription funds for equity at a future financing round. Unlike with CLNs, if the company becomes insolvent, investors are not considered unsecured creditors or holders of equity.

For both instruments, the discount rate may be applied at the time of conversion, to reward early investors with a more favourable price per share compared to new investors. A valuation cap may also be introduced, to give investors certainty on the maximum valuation at which their instrument will convert. Convertible instruments are often favoured in seed rounds because venture companies may have a limited financial history, making valuations uncertain and therefore delaying discussions around valuation until a third-party investor ascribes a valuation to what would be a more mature company.

Preferred equity refers to shares that have preferential rights to the ordinary equity, normally introduced at seed level investments and beyond. Investors will receive shares outright in exchange for their investment. Preferred shares take priority over ordinary shares, meaning preferred shareholders will be paid out before ordinary shareholders in the event of liquidation. The general principle upon liquidation is that *"the last money in is the first money out"*, and preferred shares aim to achieve that economic protection. Each round of financing often introduces a new class of preferred shares that *"stack"* on top of one another, with the ordinary equity at the bottom.

3.4 Documentation

Typical key documents representing a financing round in a growth company include the following.

Term Sheet

This is a non-binding document, used as a basis for key legal documents, outlining the fundamental investment terms and conditions between the company, the investors and sometimes the founders. The term sheet plays a pivotal role in shaping the deal and serves as a road map for further negotiations.

Subscription Agreement

This is a binding contract between the investors and the company, detailing the number and class of shares subscribed for, payment terms and warranties from the company to the investors.

Shareholders' Agreement

This is a binding contract between the shareholders, the founders and the company, which regulates the relationship between them all. The document is private and, therefore, houses matters that require confidentiality. Key provisions will include, inter alia, investor protections such as consent matters, information rights and board representation, as well as founder undertakings and covenants. The investors who are subscribing to shares in the company will be signatories to the shareholders' agreement, as well as current investors. Not all shareholders have to be privy to this agreement, but it is generally recommended.

Articles of Association

The company's constitution sets out the rights attaching to the shares, including liquidation preference, procedures for the issue and transfer of shares such as pre-emption (and any such restrictions), exit provisions, and the governance of board and shareholder meetings.

Templates

The BVCA publishes standardised templates for the subscription agreement, shareholders' agreement and articles of association for post-seed financing rounds. The purpose of these documents is to promote industry-standard legal documents, allowing investors and founders to focus on commercial, deal-specific matters, thereby reducing the frictional cost of capital to investors and companies alike. The latest update to these documents was in February 2025, with the changes in this latest update being less substantive compared to the earlier 2023 revisions to the documents.

Ancillary documents to the key legal documents include:

- the management rights letter from the company to the investor outlining matters of company management and control in which the investor may participate – these are generally seen with regulated venture capital funds to ensure they can meet reporting requirements, amongst other rights;
- a disclosure letter from the company to investors setting out the disclosures against, or exceptions to, warranties given in the subscription agreement;
- the founder service agreement setting out a founder's obligations, directors' duties and the equity vesting schedule; and
- confirmatory IP assignment agreements, sweeping up any concerns relating to historical IP.

3.5 Investor Safeguards

Investors can secure the following key terms in a downside or winding-up scenario with respect to other investors, founders and employees.

Liquidation Preference

This dictates the order and amount investors and other shareholders are returned if a liquidity event occurs. The mechanics of the liquidation preference structure are similar to other venture-friendly jurisdictions, layering share classes to create a preference stack, assigning a liquidation preference multiple for each class of shares, and participation rights (ie, non-participating preference v participating preference). If the company is wound down or sold for a lower valuation than the original investment, investors holding

preferred shares have their subscription monies returned in priority to (potentially) other preferred shareholders lower in the preference stack and, ultimately, before the holders of ordinary shares, such as the founders or employees.

Voting Rights

Investors will want to secure voting rights that provide them with influence and control in major decisions, such as the sale or winding down of the company.

It is very common to attach anti-dilution provisions to preference shares and for the benefit of a preference class as a whole. They operate to compensate/rebalance the investor's shareholding if the company raises a new round of finance at a lower valuation than the previous financing round. Such provisions will attach to a class of preferred shares and protect investors in a new round of financing either through issuing bonus shares or altering the conversion ratio of preferred shares to ordinary shares. Anti-dilution protection usually functions by applying a mathematical formula to calculate the number of new shares the investors will receive, for no or minimal cost, to offset the dilutive effect of the issue of new shares at a lower valuation.

A pre-emption right, also commonly known as *"right of first refusal"*, gives investors the opportunity to subscribe to shares on a new issue or to other shareholders' existing shares on a transfer before they are offered to third parties.

Both anti-dilution provisions and pre-emption rights are prevalent in UK VC transactions, and feature in the BVCA shareholders' agreement and articles of association standard templates.

3.6 Corporate Governance

The extent of investors' control and influence over the management of the venture will vary, depending on the terms negotiated between the investors and founders. Typical market standard rights in relation to a company's corporate governance include the following.

Director Appointment Rights

An investor or group of investors will be given the right to appoint at least one director to the company's board. This right is usually commensurate with having to maintain a specific shareholding percentage – eg, 10% of the company's share capital.

Observer Rights

Sometimes an investor will not want to be exposed to the fiduciary obligations that come with being a director, instead preferring to appoint an observer to the board. An observer will not have voting rights, but can attend and speak at meetings, and relay information back to investors. The observer role is also often used to train up more junior members of the investor's team.

Consent Matters/Veto Rights

Investors will cast votes in or be given the power to veto certain matters, such as:

- issuing new shares or amending share classes and rights;
- mergers and acquisitions;
- significant changes to the business plan and budget;
- changes to board composition;
- entering into significant investments or debt;
- exits that are not a qualifying sale, such as a secondary market transaction or winding down of the company; or
- IPO and related party transactions.

Consent matters are usually split into *"value leakage"*-type vetoes, which affect the investor's economics, as compared to more operational vetoes, which become less relevant over time as the management team gains experience.

Information Rights

The company will provide investors with specific information on a regular basis relating to the performance of the business, strategic growth plans and financial reporting to assist in keeping the investor informed on their investment (particularly if they do not have a board seat) and to satisfy their fund reporting obligations.

3.7 Contractual Protection

The subscription agreement will contain a schedule of warranties, which are contractual statements of fact made by the company (and sometimes its founders) as to the condition of its business. The warranties ensure confidence in the investment and constitute a right to bring a claim for damages should something prove to be untrue and the investor can demonstrate loss. Warranties typically relate to the ownership of shares, assets and IP, employment, the financial health of the company, any legal issues, such as involvement in disputes, and the accuracy of information provided. Sector-specific warranties are also important, depending on the industry in which the company operates.

The normal recourse in the case of a breach of a warranty is to make a contractual claim against the company itself – which essentially means the investor would be looking to recover monies from their own investment. As such, disclosure becomes very important so that the investor is entering into the transaction with their *"eyes open"*. The founders may give warranties as well, but this is rare; if they do, it is typical for their liability to be capped at a multiple of their salary, which is more common at seed-stage investments. Usually, the subscription agreement will contain a provision prohibiting an investor from bringing a claim without the consent of the majority or all of the shareholders. To mitigate the risk of breach and conflicts that arise in bringing a claim, thorough due diligence and detailed disclosure at the time of the investment are crucial.

In the US, it is standard for the warranties to be representations as well. This is not the position in UK venture capital deals because it gives rise to a misrepresentation claim where the remedy is recision or a claim in tort, rather than contractual damages, and can therefore have unintended consequences due to the different remedies.

Restrictive covenants and undertakings are a common feature of deals found in the shareholders' agreement. Restrictive covenants limit the activities of founders and key employees, both during and after their employment with the company. For example, covenants will restrict founders from being involved with any competing business or acting in a way that harms the venture. Restrictive covenants must be time limited and jurisdictionally concise in order to ensure enforceability.

Undertakings are positive obligations put on the company and founders to perform certain actions or achieve milestones. They can be specific, such as rectifying an issue discovered in due diligence, or general, such as taking all action necessary to protect the company's IP.

Breaches of covenants and undertakings will generally be remedied by specific performance or contractual damages.

4. Government Inducements

4.1 Subsidy Programmes

Government Programmes

The UK government incentivises investment in small and medium-sized, unquoted trading companies through tax relief schemes available to individuals. The three most commonly associated with venture capital are the Enterprise Investment Scheme (EIS), the Seed Enterprise Investment Scheme (SEIS) and Venture Capital Trust (VCT) relief. The schemes are expected to be available until 5 April 2035, and each serve a different purpose.

- SEIS is designed for early start-up seed capital and can be used in advance of an EIS investment. Investors benefitting from SEIS may include directors (allowing business angels to impart business advice alongside investment).
- EIS relief has a similar set of requirements as SEIS, but with higher thresholds and limits to capture post-seed investments. Note that directors are generally disqualified from investing via the EIS regime.
- VCTs are tax-approved quoted companies that invest in shares and securities in other qualifying, unquoted, trading small and medium-sized companies. VCT relief offers similar benefits to EIS/SEIS by way of indirect investment, thereby affording investors increased liquidity.

Conditions for EIS, SEIS and VCT Relief

To achieve the different purposes of each scheme, there are prescriptive conditions. However, when effectively managed, the schemes can offer investors generous tax benefits.

Some, but not all, of the key conditions required to obtain the most beneficial tax outcome for investors are listed below (note that, for VCT relief, certain conditions *"look through"* into the investments made by the VCT).

Conditions of the investee company

- Gross asset test: GBP350,000 for SEIS; GBP15 million immediately before issue and GBP16 million immediately after for EIS and investments made by VCTs.
- Full-time employees: fewer than 25 for SEIS, EIS and investments made by VCTs.
- Maximum limit: GBP250,000 on, and in the three-year limit before, the SEIS investment, taking into account other state aid (for SEIS) and GBP12 million (across all schemes – ie, EIS, SEIS and investments made by VCTs).
- Annual limit: GBP5 million (broadly, across all schemes).

Conditions of the investor

- Holding period requirement: generally, EIS and SEIS shares need to be held for three years to ensure the most tax-efficient outcomes, whilst for VCT five years produces the best tax results.
- Investor claim limits: investments of up to GBP200,000 per tax year for SEIS and VCT relief, and GBP1 million per tax year for EIS.

Note that the above conditions assume that the company in which the investment is being made is not *"knowledge-intense company"*. For investments in such companies, certain limits and thresholds may be increased. For example, the total amount of scheme (including EIS, SEIS and VCT) financing a company can receive is increased to GBP20 million; the annual limit increases to GBP10 million; and the amount of EIS relief from which an investor can benefit increases to GBP2 million.

4.2 Tax Treatment

Tax Benefits of the EIS, SEIS and VCT

Income tax

The EIS, SEIS and VCT relief offer upfront income tax deductions of 30% of the investment for EIS and VCT relief, and 50% for SEIS. Note, however, that the reliefs can be withdrawn in certain circumstances where the relevant holding period requirement is not met.

EIS and SEIS reliefs may be carried back to reduce prior-year income tax bills. The schemes reduce income tax liabilities to nil, but will not create a deficit.

Capital gains tax (CGT)

The schemes may also allow CGT relief in certain circumstances. If the relevant shares have been held for their requisite holding period and income tax relief was obtained at the time, gains on disposal should be exempt.

An individual can also defer gains made on other investments into EIS investments made within a period beginning one year before and three years after the EIS investment. In such circumstances, a future EIS loss may shelter a recrystallised gain (which would be charged at the rates of CGT when brought back into charge).

Inheritance tax

EIS and SEIS shares qualify for *"business property relief"* in respect of inheritance tax if they are held for two or more years. From 6 April 2026, *"business property relief"* provides an exemption from inheritance tax up to GBP1 million (per estate). Any assets over that threshold shall be charged at an effective inheritance tax rate of 20%.

Other Tax Benefits Available in the UK

The UK tax system is favourable to VC investors.

- Dividends – there is no withholding tax on dividends in the UK, and the receipt of dividends, whilst taxable, is subject to a number of exclusions that may apply (including, specifically, one relevant to dividends from VCTs).
- Interest is subject to 20% withholding tax, which can be offset against income taxes payable by UK resident individuals. The UK has an extensive double tax treaty network that seeks, where possible, to limit double taxation for non-UK residents. Individuals investing in trading companies, broadly, controlled by either directors or five or fewer persons may also be able to claim deductions for interest payments on debt obtained for the purchase of 5% or more of the shares. This relief cannot be used in conjunction with the EIS (which should be more beneficial, if available).
- CGT – Business Asset Disposal Relief (formerly entrepreneurs' relief) allows a 14% reduced rate of CGT (from 6 April 2025 – a 4% increase from the 10% rate applicable in earlier years), up to the lifetime limit of GBP1 million of gains. This relief is relevant to employees and directors who, broadly, also hold a 5% (economic, voting and beneficial ownership) shareholding for a two-year period prior to disposal. Alternatively, Investors' Relief may be available to similarly limit the CGT rate to 14% (from 6 April 2025 – previously 10% as above) on lifetime gains of up to GBP1 million (for qualifying disposals made before 30 October 2024 – previously GBP10 million), but for external investors only, and requires a three-year holding period. The Business Asset Disposal Relief and Investors' Relief rates are expected to rise to 18% from 6 April 2026.
- Share loss relief – where an investor has invested in qualifying trading companies, share losses may be claimed as relief against

income receipts, if conditions are met to make them *"qualifying shares"*. EIS shares are qualifying shares for this purpose (and SEIS shares may qualify if they meet the general conditions). Shares held in VCTs are unlikely to be eligible.

Venture capital investors are also often keen to ensure that investee companies avail themselves of reliefs and credits within the UK tax system, such as *"full expensing"* and *"research and development relief"*.

4.3 Government Endorsement

So far, the UK government's initiatives have primarily involved tax relief. However, the government is now focused on enhancing the appeal of the UK for the world's best and fastest-growing companies as a place to be listed, making London *"the global capital for capital"*, with a market offering innovative capital solutions not seen elsewhere. To this end, the government is committed to a comprehensive programme of initiatives to deliver on various policy goals. These have involved the following.

- Motivating pension funds to invest in riskier/high-growth assets. The Mansion House Compact scheme involves a number of large pension funds and other stakeholders charged with facilitating the deployment of capital into UK high-growth businesses (as direct investments or via funds) to deliver better returns over the long term for UK savers and bring UK pension funds into line with some of their counterparts in other regions, such as Canada and Australia, where they have a larger allocation to high-growth industries.
- Providing investment to UK start-ups through British Patient Capital and the British Business Bank.
- Seeking to regularise the arrangements governing university spin-offs.
- Regularly convening the UK venture community through its involvement in events such as UK Fintech Week and producing research and reports on how to promote the UK ecosystem (eg, the Kalifa Review of UK Fintech), as well as supporting the UK ecosystem at international conferences.
- Exploring further regulatory change to facilitate secondary trading in high-growth companies under a new regulatory framework, PISCES (see **6.3 Pre-IPO Liquidity**), to promote intermittent trading venues.
- Wholesale reform of the UK public equity capital markets regulatory framework to support increased IPO activity as well as follow-on offers.

5. Employment Incentives

5.1 General

Founders are generally incentivised if issued shares at the onset of their venture, representing the *"sweat equity"* associated with an early-stage operation. To ensure there is a longer-term retention plan in place for each founder, vesting provisions are usually built into the articles of association of the company (or, less commonly, into the shareholders' agreement, although this is a less optimal place for the provisions for enforceability purposes). Such vesting provisions serve as reassurance for investors that founders are incentivised to remain with the venture during the specified time period, by implementing a process whereby the value of the equity is earned over time, albeit issued upfront for taxation reasons, in order to potentially benefit from Business Asset Disposal Relief. If the founder were to leave prior to their full vesting period, generally (although this is up for negotia-

tion with investors) a certain proportion of their equity, based on the time served in the venture, would be either transferred/recycled to other founders or other stakeholders or more simply converted into valueless deferred shares. In more serious instances (such as fraud or gross misconduct – ie, *"bad leaver"*), all shares held by the founder would be clawed back, transferred or converted into deferred shares to protect the company's interests.

Key employees are less likely to be issued equity upfront, unless they were onboarded early following the incorporation of the company when share value is low and/or fundamental to the founding team. More commonly, key employees would be rewarded through the company's share option scheme, once implemented. In the UK, the Enterprise Management Incentive (EMI) scheme is the most common type of option scheme to implement for a venture-backed company to reward its employees, as it is specifically designed for early-stage, high-growth companies (eg, qualifying conditions include that the company's gross assets must not exceed GBP30 million and it must have fewer than 25 *"full-time equivalent"* employees). The company granting EMI options must be independent (meaning that it must not be under the control of another company), and it cannot undertake certain specified activities (such as dealing in land). It is possible to obtain advance assurance from HMRC that a company qualifies.

The benefits of an EMI share option scheme include the following.

- No income tax or National Insurance is due on the granting of an EMI option.
- If the exercise price is at least equal to the actual market value of the shares under option at the date of grant, which can be agreed with HMRC, no income tax or national insurance is payable on the exercise of the EMI option.
- If the exercise price is less than the market value, the difference will be chargeable to income tax, and potentially National Insurance at exercise.
- If the employee has held the option and/or the shares for more than two years, Business Asset Disposal Relief on CGT is available on the disposal of the option shares. Business Asset Disposal Relief reduces the rate of tax to 10% on the first GBP1 million of gains. CGT will then apply at 18% or 24% (depending on the individual's personal tax rate) for gains over GBP1 million (where gains are defined as the difference between the market value of the shares on exercise and the sum received on sale).

Employees must own less than 30% of the company in order to participate in the scheme. The maximum value of shares over which an employee can hold EMI options at any time is GBP250,000. Once this limit has been reached (for which purposes, options exercised and lapsed are included in the calculation), no further EMI options can be granted within a three-year period.

The EMI option scheme is extremely flexible in that the company is able to set any vesting and exercise terms it considers appropriate. This allows for options to become non-forfeitable based on a vesting schedule, and the exercise of options can be restricted to exit events, which may be full exits by shareholders or where there is an opportunity of a secondary sale. The above tax benefits will apply whenever EMI options are exercised.

A similar, but less flexible, tax-advantaged option scheme is the Company Share Option Plan (CSOP), which allows for options to be granted on up to GBP60,000 worth of shares. Unlike an EMI option, the option price must be set at least at market value, which can be agreed with HMRC, and tax benefits will only arise once the options have been held for at least three years, or are exercised early in certain *"good leaver"* or on certain change-of-control exit events. Given these restrictions, CSOPs are therefore generally only adopted once a company no longer qualifies to grant EMIs.

Companies may also consider replicating the benefits of an equity arrangement with a cash-based (or *"phantom"*) share scheme. Under this type of arrangement, employees and service providers are granted the right to receive a cash payment from the company equivalent to the gain that they would have made on a share option. As there are no tax benefits to such arrangements, they are not restricted in structure. As the company would need to fund the cash payments, for a venture-backed company awards will generally only vest and become payable on an exit event.

Venture-backed companies may also make use of cash-based retention bonuses for key employees, which will be paid following the individual remaining with the company for a specified period of time, and potentially achieving certain key milestones within that period. There are no tax benefits available for cash-based arrangements.

In addition to incentive arrangements, the commitment of key employees to the business will be procured through the terms on which they are employed, including through the length of the notice period that would need to be given in order to leave the employment (which will often be coupled with the company's ability to place a leaver on *"garden leave"* in order to protect the company's confidential business information). Following cessation of employment, former employees will continue to owe obligations of confidentiality and may also be subject to covenants restricting them from joining a competing business, poaching employees or dealing with clients of the company for a period following departure. Any such restricted period runs concurrently with any period spent on garden leave.

5.2 Securities

Usually, a founder's ownership is earned, or vested, over time in order to incentivise them to commit and stay with their company. Reverse vesting is the most common in the UK, where a company will issue all of the equity to the founders upfront but subject to terms under which the company will *"claw back"* some or all those shares either by repurchase, transfer or conversion into deferred shares if the founder leaves before the end of a specified period. The vesting of the shares may also be subject to the achievement of milestones during the vesting period, which, if not achieved, will similarly result in a loss of the shares. One of the advantages of reverse vesting is that the founders, who often own most of the equity, get full voting rights attached to those shares from the point of issue. From the company's perspective, reverse vesting protects the company against a situation where a founder leaves and takes all their shares with them.

The company is free to set whichever vesting period and milestones it considers appropriate for the business. As the shares are subject to *"forfeiture restrictions"*, the founder will generally enter into *"restricted securities election"* with the company to ensure that any liability for income tax is limited to the point of acquisition, and not

on a later sale or lifting of restrictions. Founders will generally pay the unrestricted market value for the shares (which at the inception of the company may be nominal value) to ensure that no tax charges arise – any discount would be chargeable to income tax and, possibly, National Insurance, depending on the holding structure of the company.

5.3 Taxation of Instruments

Where key employees are to acquire shares at a later stage in the company's development, care needs to be taken that those shares are acquired at the unrestricted market value; otherwise, an income tax, and possible National Insurance, charge will arise on the difference between the market value and the subscription price paid.

Given that there may have been significant growth in value of the company since inception, where options are not being granted (for example, because it is desirable for the individuals to have shareholder rights, such as the right to dividends or voting rights), it may be appropriate to consider issuing a new class of *"growth share"* to such employees. Growth shares are a separate class of shares that have rights only to a proportion of the increase in the value of the company from the date of acquisition, rather than including value that has accrued prior to the date of issuance. Shares will therefore be issued with a company value hurdle, below which the shares will not participate in liquidation value.

A valuation of such growth shares, taking into account the level at which the hurdle has been placed (which, in order to reduce the valuation, may need to be set at a premium to the company's market value) will need to be undertaken to ensure, in order to avoid upfront tax, that shares are being subscribed at unrestricted market value. As described above, the employees will generally have to enter into *"restricted securities election"* with the company to ensure that any liability for income tax is limited to the point of acquisition, and not on a later sale or lifting of restrictions.

5.4 Implementation

When looking to establish an incentive arrangement for employees, the company will need to consider any restrictions that have been included in its articles of association or shareholders' agreement in relation to dilution, pre-emption rights and requirements for shareholder approval or investor (director) consent.

The establishment and terms of any share incentive arrangement will be negotiated between the company and its management, existing investors and any new investor at the time of an investment round, and the proportion of share capital that will be available to employees, and will therefore dilute investors, will form part of those negotiations. At later-stage investment rounds, where investors are acquiring preference shares rather than ordinary shares, the dilution will be after the return of capital and any associated coupon on the preference shares, and so investors are able to set a minimum return by way of the preference coupon before employees share in the further accrued value.

6. Exits

6.1 Investor Exit Rights

The shareholders' agreement and articles of association will detail exit provisions and transfer restrictions that govern shareholders' rights in the event of an exit trigger such as an IPO, sale of the company, or winding down of the company. Since 2013, a total of 5,899 high-growth companies have exited in the UK via an

acquisition or an IPO, according to research by Beauhurst.

Exit Provisions

Liquidation preferences

These dictate the order and amount of investors and other shareholders in capital returned during a liquidity event. The mechanics of the liquidation preference structure are based on the structure of the preference stack, liquidation multiple and participation rights. If the company is wound down or sold for a lower valuation than the original investment, investors holding preferred shares will most likely have their capital returned before holders of ordinary shares, such as the founders or employees.

Drag- and tag-along rights

Drag-along rights favour majority shareholders who want to sell the company by empowering them to compel minority shareholders to participate in the sale. Tag-along rights are the natural inverse to drag-along rights, which provide protection for minority shareholders by ensuring they can participate in the sale on the same terms as the majority shareholders and not be left in a company where a majority of shareholders have sold out.

Vesting schedules

See **5.1 General**. In a liquidation event, a vesting schedule may be accelerated to allow founders to realise the full value of their shareholding earlier than forecast. The same may apply to option schemes, whereby *"single-trigger"* acceleration would allow option holders to exit in full upon M&A. US acquirers will be used to *"double-trigger"* event, where the exit is only one part of the acceleration but another condition must be met to accelerate in full (ie, a further retention period with the acquiring entity). This is often a discussion/negotiation point in acquisitions, and due diligence is required upfront.

Conversion of shares

In the event that the qualifying threshold for an IPO is met, all preference shares will be converted to ordinary shares. Generally, any investor can request that their preference shares be converted at their instruction.

Registration rights

When an IPO takes place on a US stock exchange, investors are entitled to registration rights, which include demand rights and shelf and *"piggyback"* registrations to ensure that all shares are listed.

Transfer restrictions

Transfer restrictions include:

- pre-emption rights on transfer that give shareholders a right of first refusal to purchase any shares up for sale before they are offered to third parties;
- a lock-up period of (typically) 90–180 days after an IPO, during which shareholders are prohibited from selling their shares to safeguard investors, ensuring long-term dedication; and
- consent – shareholders may be restricted from transferring their shares without consent from the board or other shareholders; founders, in particular, may be locked in permanently or for a certain period of time, again to ensure the orderly functioning of the business and that management is retained.

6.2 IPO Exits

IPO exits have historically been the natural progression for a venture company that has been growing rapidly for a number of years. Various external and internal factors – eg, business per-

formance, competitive landscape and market conditions – play a role in accelerating, delaying or even impeding a company's exit and IPO timeline. IPO exits in the UK peaked in the third quarter of 2021, with both the number and value of IPOs of high-growth companies hitting a record level, representing a combined market capitalisation of GBP20.6 billion.

IPO exits globally have recently experienced a protracted slowdown, driven by high interest rates, rising inflation and the impact of these macroeconomic factors on valuations, as well as aftermarket performance difficulties suffered by recent IPO candidates. This challenge to the global public equity markets has led to an increased focus on regulatory reform, including in the UK and the European Union, to boost the attractiveness of the equity capital markets; it has also led to increased competition from New York as a listing venue. In response to this, the FCA is implementing a radical restructuring of the UK Listing Rules to attract more companies to London. The Listing Rules reforms have been generally well received by the market.

6.3 Pre-IPO Liquidity

PISCES

There is a tangible market need for secondary market trading prior to an IPO to facilitate liquidity. Faced with the slowdown in IPO activity due to the global economic climate, secondary transactions provide a mechanism for early-stage investors, founders and employees to reclaim all or part of their investments whilst allowing companies to remain private. Investors are more likely to invest, and employees to be retained, if the opportunity exists to sell equity before an IPO. Secondary market trading also means that new investors can tap into the potential of more mature and experienced companies.

It is a common strategy for founders to sell down a portion of their shareholding to incoming investors in a new financing round, in order to receive some liquidity for all their hard work to date. Founders may offer a discount to the investor, and this can help the investor achieve a blended rate for their investment acquisition cost while offering an opportunity for founders to secure their financial future, given that they may have worked on very modest salaries for some time. This is generally seen as a positive experience for both parties, and is very common on later-stage (Series B) transactions.

The key challenges presented by secondary market trading include:

- the lack of transparency and readily available information about private companies compared to public companies;
- regulatory hurdles and compliance with securities law; and
- conflict between companies and shareholders, with the former wanting to maintain control of their equity trading via structured liquidity events such as tender offers and auctions, and shareholders preferring streamlined access to the isolated liquidity event of a direct secondary sale.

To address these issues, the FCA will implement and operate a new form of regulated trading platform, allowing for the intermittent trading of shares in unlisted companies in the UK, called the Private Intermittent Securities and Capital Exchange System, or *"PISCES"*. Following a consultation in March 2024, HM Treasury confirmed it will proceed with the proposal and legislate for the platform's establishment in a regulatory *"sandbox"*.

The government predicts that PISCES will *"support the pipeline for future IPOs in the UK, by improving the interface between private companies and UK public markets"*. Intended to provide greater protection and regulation than offered by the current private secondary trading market but remaining a lighter-touch approach than public regulated markets, PISCES will bridge the gap between the two with a standardised and controlled private trading environment.

In December 2024, the FCA published CP24/29, setting out its proposal on how PISCES might work in practice. The FCA is taking *"private-plus"* (as opposed to *"public-minus"*) approach to its PISCES rules, proposing a bespoke regime that builds on private market practices on *"buyer beware"* basis, rather than using public market standards as a starting point. The key legal and regulatory parameters of the draft legislation include:

- shares being traded intermittently during *"trading windows"*;
- restrictions on the categories of investors that can trade on PISCES;
- the stamp duty/SDRT position mirroring the Alternative Investment Market (AIM) and so stamp duty will not apply, as well as shares traded on PISCES benefitting from business property relief (see **4.2 Tax Treatment**);
- disclosure requirements to investors who may trade in a specific window but not to the public – there is also an overarching requirement on the PISCES operator to maintain appropriate disclosure arrangements for the proper functioning of its market, and the criminal market manipulation regime will apply; and
- a market abuse regime (which is not a public market-style) tailored to the intermittent nature of trading and the specific risks posed.

HM Treasury published a draft statutory instrument (SI) and accompanying policy note setting out the PISCES framework in November 2024, and aims to introduce the PISCES legislation by May 2025. On 17 December 2024, the FCA published a consultation on its proposed rules for PISCES. The consultation closed on 17 February 2025 and it expects to publish the final rules by May 2025, before opening the PISCES Sandbox for applications.

7. Regulation

7.1 Securities Offerings

A venture capital-backed IPO is the initial offering of shares of a company that has been mainly funded by venture capital investors. For an IPO in the UK, an offering of shares to the public requires the publication of an FCA-approved prospectus. The UK Prospectus Regulation and Financial Services and Markets Act provides that a prospectus must contain the necessary information that is material to an investor for making an informed assessment of:

- the assets and liabilities, profits and losses, financial position and prospects of the company;
- the rights attaching to the shares; and
- the reasons for the issuance and its impact on the company.

When preparing the prospectus, it is important to consider the following.

The "Equity Story"

The equity story is fundamental in highlighting the strengths of the company, its potential for growth and any key risks associated with the business. It includes the description of the business model, its market environment and growth

prospects. A compelling equity story for the IPO will include information on market drivers and unique features compared to competitors. The equity story will appear in the prospectus, most notably in the founder's letter and business overview, but it is also used for marketing and book-building purposes.

Key Employees/Management

The company's senior management will remain important to the business after IPO, so the prospectus will include a section on directors, senior managers and corporate governance. New share plans for employees and executive directors are usually put in place as part of the IPO process and described accordingly. It is market practice to include a summary of the expected remuneration policy in the prospectus, if the company has made these decisions prior to the IPO, which is then put to the shareholders at the company's first post-IPO general meeting.

Financial Information

The prospectus must contain audited historical financial information on the company and its group, covering the latest three financial years and the audit report for each year. High-growth companies have struggled in the past to meet current track record requirements (eg, pre-revenue companies such as e-commerce and technology companies, acquisitive companies in the biotech, fintech and pharmaceutical sectors and other companies following *"roll-up"* acquisitive strategy), which the FCA has taken into account when proposing changes to the UK Listing Rules.

IP/Data Protection

Companies may find that IP issues not adequately addressed or altogether ignored suddenly become material problems leading up to or following an IPO, sometimes leading to multiple shareholder claims after the IPO, causing the share price to tumble. For high-growth companies with a large amount of intangible assets, having an IP strategy in place protects these critical products and services, and can maximise enterprise value.

Tax and Structure

Investors may favour companies with a particular company structure, such as the insertion of a holding company that will be the listing vehicle. In addition, companies might choose to re-incorporate in another jurisdiction if they want to take advantage of more flexible governance requirements or a particular tax structure.

7.2 Restrictions

The UK's National Security and Investment Act 2021 (NSIA) introduced new powers for the government, acting through the Investment Security Unit of the Cabinet Office (ISU) to review investments that it considers may give rise to a risk to the UK's national security.

Investments of more than 25% into businesses that have activities in one or more of 17 specified sectors may be subject to a mandatory notification obligation, which requires the parties to notify the transaction to the ISU and obtain clearance prior to completion.

Investments that do not trigger a mandatory filing but still give the investor material influence over UK activities may be *"called-in"* for review if the government considers that they may give rise to a risk to national security. This power is exercisable at any time up to six months after the government becomes aware of the transaction, provided this is also within five years of the relevant transaction. Parties may therefore choose to submit a voluntary notification to the

ISU, in which case this period is reduced to 30 working days.

Where a transaction is found to give rise to national security risks, the range of potential remedies is broad and can ultimately include prohibition or unwinding of the investment. Other examples of remedies have included:

- restrictions on transfers to the investor of sensitive information, technology or intellectual property;
- requirements for UK governmental approval of future commercial conduct;
- requirements to appoint government-nominated board members; and
- requirements to keep certain capabilities within the UK.

The NSIA regime applies equally to investors of any nationality, both UK and foreign. That said, an investor's nationality is likely to be a relevant factor, especially when considering any possible links to actors that may pose a security threat to the UK.

Trends and Developments

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Herbert Smith Freehills LLP offers a global venture capital and growth equity practice with a deep bench of specialist practitioners across the world, including in the UK, Germany, France, Spain, Italy, Singapore, Australia, South Africa, the US, UAE and Saudi Arabia. The UK team consists of 20 dedicated lawyers who cover all aspects of venture capital and growth equity, across multiple sectors. The firm emphasises a blended practice across early-stage and late-stage transactions, acting for companies, institutional investors and corporate venturing houses alike, and across the entire life cycle from seed to exit, including IPOs. It has extensive sector capabilities and established practices, acting for scale-up companies, particularly in the tech, fintech, cleantech, life sciences, media and sport and consumer sectors. This material was researched and written by Dylan Doran Kennett, Michael Jacobs, Stephen Newby, Mark Ife, Veronica Roberts, Casey Dalton, Zoe Wilson, Jhanelle Bisasor, Evan Li, Emily Travers, Theo Pickles and Mohamed Sabry Salama.

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Venture Capital in the UK: an Introduction

After a challenging period, 2024 witnessed the encouraging signs of a long-awaited recovery in the venture and growth capital market. This rebound has gained momentum, and the outlook for fundraisings, liquidity and exits is promising, balanced against continued macroeconomic and geopolitical uncertainty. Overall, as we look forward to 2025, the venture capital market is likely to accelerate throughout the year.

Looking back to 2024, and despite the difficulties faced by the global markets over the past year, the UK investment climate has remained strong, surpassing Germany, China and India to become the second most important destination for investment (after the US), according to PwC's Annual Global CEO Survey for 2025. In Europe, the UK regained its dominance in capital raised in 2024, being responsible for 36.6% of the European total (an increase of more than 10% year-on-year) and attracting more investment than France and Germany combined, according to data from HSBC Innovation Banking. Venture capital deal making in the UK also rose to the highest level in seven quarters in Q4 2024, according to data from Pitchbook.

The resilience of the UK's VC market has been driven in part by improved macroeconomic conditions across inflation and interest rates, positive trends in valuations and investment terms, and improved sentiment in the UK ecosystem against a backdrop of significant regulatory and legislative reforms aimed at maintaining the country's competitive edge for start-ups and investors, but also as a result of the strong pipeline of UK start-ups across key areas of the emerging technologies, which is driving demand on the investor side.

Globally, average deal sizes increased across all venture capital stages, fuelled largely by a surge in funding for AI-related investments, according to data from Bain & Company. Transactions involving corporate venture capital accounted for 35% of total equity funding in 2024, the highest share since 2019, suggesting a significant and growing influence of venture capital in the equity markets.

Looking Back: Reflections on the Last 12 Months

Seed and early-stage companies are the most attractive to investors

Transaction trends analysis by HSBC Innovation Banking has shown that investors are increasingly choosing to invest in seed, early-stage and breakout-stage companies. Investing in a seed-stage company offers investors the opportunity to capture value by backing companies in their early stages, when valuations are typically at their lowest, and acquire early minority ownership positions that can be maintained or increased in subsequent rounds.

This trend was most apparent following the explosion in generative AI, when numerous venture capital funds pivoted to this relatively earlier-stage sector and to the deep tech, cleantech and life sciences segments. As a result of these trends, the median deal size for seed companies in the UK has risen, reflecting the escalating ambitions of start-ups and their commensurate capex needs and the confidence of investors selecting *"hot"* sectors. In 2024, seed funding in the UK continued to be dominated by domestic investors, with around 57% of total early-stage funding coming from the UK, although US funds are entering the seed stage in the UK and Europe at a rapid rate, particularly in the tech and life sciences sectors.

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There are a number of reasons for this increased interest in investing in seed, early-stage and breakout-stage companies. In certain sectors, such as generative AI, the opportunities arising from the emergence of this technology have resulted in many start-ups leveraging the UK's historical strength in the underlying science. For instance, British AI company Wayve secured around GBP840 million to develop AI-powered self-driving vehicles in the UK's largest venture capital funding round of 2024. British AI-enabled travel and hospitality platform Lighthouse also had an impressive EUR350 million Series C funding round led by KKR, leading to the company achieving unicorn status in the process.

Furthermore, tax-advantaged investing under the Seed Enterprise Investment Scheme/Enterprise Investment Scheme (SEIS/EIS) programmes in the UK continues to be the bedrock for facilitating early-stage investment from UK tax-resident angels. These flagship programmes remain incredibly attractive for early-stage investors, and are a means for companies to attract risk capital early in their journey. Demonstrating its support of early-stage enterprise, the government has confirmed that the EIS will be extended to 2035.

Looking at exits, whilst the number of companies launching their initial public offerings (IPOs) remains subdued in the UK and in other markets, such as the US, the IPO pipeline is very significant and IPO activity is expecting to increase rapidly throughout the year and into 2026. Klarna's upcoming US IPO should help to boost the tech IPO environment, especially in fintech.

The UK's M&A activity and deal value have seen a modest increase in 2024, as reported by PwC, with 2025 expected to see more private equity activity both on the sell side (as many portfolio companies have been owned beyond their usual hold periods) and on the buy side, with funds continuing to sit on surplus funds ready to be invested. As of today, the constrained exit environment does limit exit opportunities for late-stage investors and, by extension, impacts late-stage deal-making, creating more limited capital recycling in the later-stage funding market, with investors focusing their dry powder on earlier-stage companies in these core sectors. The expectation is that these constraints should alleviate throughout 2025 and 2026.

Fundraising at the seed stage is often more insulated from the volatility seen in public markets and the valuation of listed peers observed over the past few years, with early-stage investors taking a seven to ten-year view, which is beyond the current forecast horizon for macroeconomic trends such as inflation and interest rates, the volatility of which has also impacted public and private market valuations.

Exit opportunities: IPO or sale versus secondary fundraising

A company naturally reaches a stage in its growth where its investors start looking to realise their investment. Challenges in achieving an exit or otherwise realising value were the key driver behind extended hold periods in 2024 (with macroeconomic themes also playing their part), as investments were kept for longer. For example, of the 181 unicorns in the UK, 69 are yet to exit through IPOs or M&A, according to HSBC Innovation Banking.

The subdued exit landscape, together with the broader challenges in the VC/growth capital market, has led to the higher prevalence of internal rounds – ie, rounds of funding in which all existing investors participate. Historically, internal rounds may have been considered a sign

that a company could not attract outside third-party capital, but this perception has evolved. Internal rounds are now expected to continue in the short to medium term as early-stage investors back their existing portfolio and take opportunities for secondary sell-downs as part of the internal rounds.

A similar feature is the continued growth in large-scale secondary sale processes, where existing shareholders can sell their stake to an investor, which also saw an uptick in 2024 for the same reasons. This trend is expected to continue into 2025, particularly for very successful companies, as early investors look to crystallise some gains and to give employees and founders an opportunity to generate some liquidity given the extended hold period.

In some cases, new and existing investors have also been able to capitalise on falling valuations and liquidity challenges by imposing investor-friendly terms during new funding rounds, as well as securing additional upsides (such as equity warrants or other forms of convertible instruments with de minimis subscription amounts). In some instances, funding rounds have consisted entirely of convertible instruments to avoid crystallising a formal valuation of the business in the hope of weathering the economic storm.

"Down rounds", where a company offers additional shares for sale at a lower price than the previous financing round, hit a decade-high in 2024, as reported by Pitchbook. Down rounds often have the effect of existing shareholders being issued with additional shares in the company under anti-dilution provisions to compensate their having invested at a higher valuation in a previous round. In 2024, nearly 25% and 18% of VC deals in the US and Europe, respectively, were down rounds. Looking forward, the proportion of down rounds in total deal making is anticipated to decrease as valuations continue to improve.

Valuations

As the era of low interest rates appears to have come to an end, at least for the next cycle, the macroeconomic implications have affected the long-term valuations of many high-growth companies, alongside sectoral trends, such as the implications of generative AI on the business models of many Software as a Service (SaaS) businesses.

Valuation, liquidation preferences and anti-dilution provisions are some of the most heavily negotiated commercial issues during a fund-raising, as they determine the percentage of the company that the investors will own as part of their investment and how these percentages can be affected in future down rounds, and affect how much money investors will receive on an exit. Founders are finding alternative ways to maintain trading momentum without undervaluing the company, such as the use of convertible instruments, thereby extending the company's runway without having to revisit the valuation of a business. In response to this, investors have focused on how companies manage costs and their cash runways. That said, a company can only issue so many convertible loan notes before an equity round is forced to crystallise a new valuation.

In March 2025, the Financial Conduct Authority (FCA) published its anticipated review of private market valuation practices. The FCA emphasised the importance of clear oversight, consistent valuation practices and timely revaluations, indicating that its forthcoming regulatory updates will aim to ensure fair pricing in UK private markets.

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Looking Forward: Key Developments in the Short to Medium Term

AI investment driving deals in 2024

While investors globally remained very cautious with their investments, conducting greater levels of due diligence than in recent years and focusing primarily on companies with very strong business strategies and paths to profitability, AI has been the exception.

2024 was a record-breaking year across the entire AI value chain. Investments into AI companies developing large language models were well publicised. The most prominent deal of the year was OpenAI's USD6.6 billion funding round, which brought its valuation to USD157 billion. Total investment into AI companies developing the tools and infrastructure for AI development (eg, data centres) was also significant. For instance, UK-based GreenScale, a sustainable data centre platform, received a GBP1 billion investment from Digital Transformation Capital Partners, an investment management firm with a focus on digital transformation, in November 2024.

There are no signs of slowing down for AI companies in this segment. Analysis by Morgan Stanley projects that power demand from generative AI will increase at an annual average rate of 70% through 2027. Recent advancements in AI have also revitalised the legal tech sector, as evidenced by Harvey AI's recent USD300 million Series D funding round.

Increased regulation in emerging tech sectors

In response to this surge in AI-related investments, legislators across the world have stressed the importance of providing legal certainty for investments and innovation in AI. In August 2024, the EU AI Act officially entered into force, aimed at ensuring that *"humans maintain control"* of the technology for the protection of consumers.

The UK government has continued to develop its *"pro-innovation"* approach to AI regulation. In February 2025, the UK published the *"Artificial Intelligence Playbook for the UK Government"*, aimed at supporting AI innovation while ensuring responsible and ethical use of AI. This followed on from the UK government's 50-point *"AI Opportunities Action Plan"* in January 2025 and the creation of the AI Safety Institute in November 2023 out of the Frontier AI Taskforce. Broader UK AI government reforms include proposals to amend UK copyright reforms as well as a potential AI Safety Bill, which is under consideration by the government.

Overall, the UK's current trajectory in AI regulation seeks to promote technological innovation while implementing measures to safeguard ethical standards and public interests.

Commercialisation of university spin-outs in the UK

A university spin-out is a company formed based on research by a university, primarily to exploit the intellectual property that has been developed. According to research from Beauhurst, as of April 2024 there were 1,317 active spin-outs from UK universities. Of these, the most dominant spin-out sectors include life sciences, climatetech and cleantech, although AI still tops the rankings of emerging sectors.

The challenges faced by UK university spin-outs are complex, with challenges in navigating university governance structures and excessive equity stakes being significant barriers to commercialisation. In November 2023, the UK government published a report following

an independent review of university spin-out companies. The purpose of the review was to identify best practices in turning university research into commercial success. The report welcomed ongoing reforms to support scale-up capital, such as changes to pensions regulation and encouraging the government to accelerate these efforts and reforms affecting UK capital markets. The UK government accepted all the recommendations from the review and recognised the important role university spin-outs play in the UK's innovative investment economy.

According to Beauhurst, the average equity stake taken by universities in 2023 was 22%, which many founders and investors argue is too high and stifles growth potential. This sentiment is echoed in the *"Reviving UK Investment Flows"* report, published by New Capital Consensus, an independent policy institute that focuses on rethinking the UK investment system to better connect capital to long-term, productive uses. The report highlights the need for a more streamlined and supportive structure to foster innovation and entrepreneurship. The report also encourages pension funds to invest more in high-growth companies, recognising the need for higher returns and diversification. By steering investments towards riskier, alternative assets like private equity and venture capital, pension funds can support innovative enterprises and contribute to economic growth.

However, there are signs of improvement. The Times reported in March 2025 that the average stake taken by universities in tech spin-outs dropped to 16.1%, a ten-year low, according to a Beauhurst study commissioned by the Royal Academy of Engineering.

Similar to its predecessor, the current UK government continues to emphasise its commitment to supporting university spin-outs and unlocking further funding. In its manifesto released in June 2024, Labour pledged to *"work with universities to support spin-outs"*. Bipartisan support for university spin-outs in the UK is a promising prospect for founders and investors. As of January 2024, 56.7% of active university spin-outs were at the seed stage, according to Beauhurst, indicating strong growth potential for innovation within the UK.

Research from Sifted showed that 40% of the ten fastest-growing university spin-outs in Europe in 2024 were from UK institutions. In addition, the recent revival of the Oxford-Cambridge Arc, a railway line connecting Oxford and Cambridge, is expected to unlock significant innovation and further university spin-outs. Improved connectivity will facilitate collaboration, attract investment and drive long-term economic growth, making it easier for talent and businesses to thrive in these regions.

Mansion House reforms

In his Mansion House speech in July 2023, then Chancellor Jeremy Hunt introduced proposals to reform the UK's pensions sector, aimed at *"boosting returns and improving outcomes for pension fundholders whilst increasing funding liquidity for high-growth companies"*. The proposals were confirmed and progressed in a comprehensive package of reforms released in the UK government's Autumn Statement in November 2023 and have been built upon by the current government.

These reforms are predicted to unlock more than GBP80 billion of financing for unlisted equity investment, with some of the most significant reforms pertaining to venture capital investment, including the following.

Contributed by: Dylan Doran Kennett, Michael Jacobs, Stephen Newby and Mark Ife,
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- Chancellor Rachel Reeves' November 2024 Mansion House speech, and an accompanying interim report, on the government's pension reforms relating to the creation of consolidated mega-funds, which will mirror the large pension schemes existing in Canada and Australia. The proposal includes a minimum size for workplace defined contribution (DC) schemes. The government does not say what the minimum might be, but cites claims that benefits start to arise at an assets under management (AUM) value of GBP25–50 billion. The proposals also include plans to accelerate the pooling of the assets of the Local Government Pension Scheme (LGPS), one of the largest UK public sector defined benefit pension schemes. For context, the LGPS is comprised of more than 80 separate funds managed by independent local authorities (an administering authority, or AA), which are now consolidated in eight asset pools.
- Committing GBP250 million to a new Long-term Investment for Technology and Science (LIFTS), matched by Phoenix Group for a combined GBP500 million, to establish new funds or investment structure to unlock UK institutional investment into science and technology companies, which was completed in November 2024.
- The *"Mansion House Compact"*, an agreement which so far has committed 11 of the UK's largest DC pension schemes to allocating at least 5% of their default funds to unlisted equities by 2030. In alignment with the Mansion House Compact, Schroders plc and Phoenix Group have collaborated to establish Future Growth Capital, the first UK-dedicated multi-asset Long-Term Asset Fund, aiming to connect long-term savings directly to private UK companies, supporting their growth and helping them remain in the UK.
- The establishment of a Growth Fund investment vehicle within the British Business Bank, in addition to the permanent capital base of more than GBP7.9 billion to give pension schemes access to opportunities in the UK's most promising businesses.
- The establishment of a Science and Technology Venture Capital Fellowship to train up the next cohort of venture capital investors.
- Doubling the limit on allocations in private equity investments to 10% for the defined benefit LGPS.

The British Private Equity & Venture Capital Association embraced the reforms by launching the *"Investment Compact for VC and Growth Equity"* (the IC), a voluntary commitment that complements the Mansion House Compact. The IC aims to facilitate collaboration between venture capital and growth equity funds with pension advisers to encourage pension scheme investment in start-ups. There are already more than 100 signatories on board, working with pension funds from October 2023 to spring 2025 to implement and deliver the IC's proposals and advance the government's reform agenda. The Lord Mayor of the City of London has also indicated his plans to encourage the scope of the reforms to be broadened to include London-listed companies.

Some of the Mansion House Compact signatories initially expressed concerns over implementing the agreement, as reported by the Financial Times. Challenges such as the inevitable increase in charges following the introduction of unlisted equities to existing default funds, as well as concerns around the appropriateness of the risks inherent in investing in high-growth assets, will need to be carefully considered by the industry. The Pensions and Lifetime Savings Association emphasised that the proposals will

not in and of themselves lead to more UK investment, and that an adequate supply of investable assets and delivery of broader changes to UK growth will also be key to creating a strong pipeline of opportunities. Leading pension funds have confirmed their support of the UK government's ambitions to increase venture and growth capital investment.

Revamp of the UK listing regime

To improve the competitiveness of the UK's equity capital markets, the FCA has implemented a radical set of reforms to the UK listing regime, which regulates the way companies list on the London Stock Exchange and their continuing obligations. The new Listing Rules, effective from 29 July 2024, overhauled the UK's listing regime to align it more closely with international market standards whilst maintaining high standards. The reforms are aimed at encouraging a more diverse range of companies to list and grow on UK markets, while promoting more opportunities for investors. The new Listing Rules included several key components, such as:

- consolidating the premium and standard listing segments into a single listing category for commercial companies – the Equity Shares (Commercial Company), or ESCC – which is fully eligible for FTSE Russell index inclusion;
- eliminating the need for three years of historical financial information and *"clean"* working capital statement in order to be eligible, and making dual class shares fully available to ESCC companies;
- removing mandatory requirements for controlling shareholder agreements;
- removing shareholder approvals for significant/Class 1 transactions (except in the case of reverse takeovers) and related party transactions; and
- reducing the burden of the sponsor role post-IPO for ESCC listings, which will now largely be limited to reverse takeovers, related party transactions or share issuances requiring a prospectus (among other matters).

The new UK Listing Rules also have brought a direct benefit to institutional venture capital investors, as such investors may now hold enhanced voting rights for a period of up to ten years following IPO. Founders and other natural persons can hold dual class shares without a time limit.

As 2025 progresses, the market can expect additional reforms in the form of an overhaul of the UK Prospectus Rules. The FCA consulted on the new Prospectus Rules between July and October 2024, and aims to finalise them by the end of H1 2025. The FCA has stated that the proposed reforms aim to lower the cost of listing in the UK, make raising capital on UK listed markets easier, and do away with barriers to retail participation.

USA

Law and Practice

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Cravath, Swaine & Moore LLP has been known as one of the premier US law firms for more than two centuries and maintains offices in New York, London and Washington, DC. The firm advises technology companies, venture capital investors and other advisers and capital sources on a wide range of pivotal transactions. Cravath's corporate clients include venture capital- and private equity-backed businesses across software, hardware, fintech, blockchain and digital assets, artificial intelligence, biotechnology, medical devices, cleantech and renewables and other developing areas, and its investor representations include venture capital and growth equity firms, corporate venture capital arms and other institutional partners. The firm's interdisciplinary venture capital & growth equity practice focuses on venture investment rounds and other financing arrangements, including preferred equity, SAFEs, venture debt and traditional and synthetic royalty arrangements; joint ventures, collaboration agreements and licensing arrangements; and employee tender offers and other pre-IPO liquidity events.

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1. Trends

1.1 VC Market

The AI sector drove momentum in the venture capital market throughout the past year. Databricks, a data and AI company, raised USD10 billion in a funding round, valuing the company at more than USD62 billion. The investment was the largest round of the year, topping the USD6.6 billion raised by OpenAI in October 2024 at a post-money valuation of USD157 billion. Other generative AI companies, including xAI and Anthropic, also raised significant rounds, with xAI raising two rounds of USD6 billion each and Anthropic raising two rounds of USD4 billion each. At the beginning of 2025, OpenAI also announced the Stargate Project, a joint venture which will seek to invest USD500 billion over the next four years in new AI infrastructure in the United States.

Due in part to these notable transactions in the AI sector, venture capital deal values rose to USD209 billion in 2024 despite deal volumes falling to the lowest level since 2019. US exit values rebounded to USD149 billion in 2024. M&A activity accounted for more than 50% of the total US exit value, which has remained relatively unchanged since last year.

While the AI sector is widely expected to continue driving venture capital deals in 2025, there are also reasons to believe that the US venture capital market more generally may rebound over the course of the year. The perception of a more business-friendly regulatory environment has been expected to fuel a rise in capital markets activity. However, the beginning of 2025 has been tumultuous, as investors have become concerned about slowing growth in the market and rising prices, largely tied to rapidly changing policy from Washington, DC around tariffs, federal spending and broader geopolitical uncertainty.

Many companies paused fundraising efforts in 2023 and 2024 at the risk of facing a decreased valuation, but will need to raise additional capital soon to extend their runways. Undeployed capital at investment firms (also known as *"dry powder"*) has hit record levels (estimated to have reached USD308 billion in the USA at the end of 2024), which is also pressuring these firms toward near-term investments.

1.2 Key Trends

Amid a challenging climate for venture capital activity, some growth companies have thrived in the financing market while many others have struggled. For companies that have faced financing challenges, *"down round"* raises, *"cramdowns"* and investor-friendly deal terms have been used in increasing frequency in order to close financing rounds. Bridge financing solutions and alternative financing solutions have also remained prevalent.

For trending companies, particularly in the AI sector, investors have accepted less-favourable deal terms and are turning to creative structuring solutions to participate in funding rounds. The use of special purpose vehicles (or SPVs), in particular, is a growing trend.

Down Rounds, Cramdowns and Investor-Friendly Deal Terms

Down rounds – ie, equity financings where a company sells equity at a valuation that is lower than a valuation achieved in the immediately preceding raise – accounted for 15% of completed financing rounds in 2024.

A *"cramdown"* describes a situation in which existing investors lead a new financing that

includes terms that may be severely punitive to non-participating investors by including other features such as forced conversions, pay-to-play mechanisms, super-priority liquidation preferences and special voting rights. Cramdowns may be a means for affecting a down round.

In light of a subdued market for venture capital investments, certain deal terms have also become increasingly investor-friendly. For example, liquidation preferences – ie, fixed payouts for investors upon the occurrence of a liquidation event like a sale or other exit – are typically set at 1x their investments in competitive market environments. In recent years, however, some investors have been able to obtain 2x or even 3x multiples. Terms granting investors participating liquidation preferences – ie, the right to share in additional proceeds after the fixed liquidation preference is returned – and cumulative dividends have also become more common.

Bridge Financings

Growth companies have also been utilising convertible debt and Simple Agreement for Future Equity (SAFE) instruments as forms of bridge financing to avoid down round valuations. These tools, which are traditionally used by companies to raise capital prior to their first priced equity round with outside investors, allow investors to put in capital that will convert into shares of the company at a discount to a subsequent priced equity round.

Alternative Financing Solutions

Some growth companies are utilising venture debt – ie, loans specifically designed for venture capital-backed growth companies – to fund their operations and defer a priced financing round and/or equity valuation. Venture debt is also frequently accompanied by an equity component, such as warrants in the company.

Asset-based lending provides growth companies with the ability to borrow funds secured by their underlying assets. This option is particularly useful for companies that have significant assets (such as accounts receivable) on which to secure a loan, but may lack the cash flows typically required for a traditional loan.

Other options include financing on the basis of annualised recurring revenue, royalty arrangements or registered IP, licensing and collaborations as well as other strategic partnerships coupled with a capital infusion from the external partner.

Uptick in SPV Activity

The use of SPVs is rising among investors. SPVs aggregate funds from multiple investors for a specific business purpose. In the venture capital community, SPVs allow investors to pool funds and participate in a funding round through a single investment vehicle. A growing number of venture capital firms themselves are also beginning to use SPVs as a means to pool funds from co-investors and invest in larger funding rounds or secondary transactions that would otherwise be outside of their investment parameters.

1.3 Key Industries

As noted in **1.1 VC Market**, the AI sector has continued to drive significant activity in the space. In 2024, venture capital funding in AI increased by 29%, accounting for roughly 46% of total deal value.

The software sector in the USA, which includes software-based AI companies, saw the highest numbers in terms of both deal number and combined deal value in 2024, with 5,560 deals and USD89 billion in proceeds in the sector. The commercial products and services sector posted the second-highest number of deals and the

second-highest total deal values in 2024, with 2,065 deals and USD29 billion in proceeds.

Exit activity in the USA was similarly driven by the software sector, with 517 deals and USD60 billion in deal value. The pharma and biotech sector experienced the second-highest number of exits by deal value, with USD40 billion across 82 deals.

2. Venture Capital Funds

2.1 Fund Structure

Sponsor and Investor Roles

Venture capital funds in the USA are typically organised as limited partnerships or limited liability companies (pass-through for tax purposes) and structured as private, closed-end, pooled investment funds, with exceptions for evergreen structures adopted by certain well-established venture capital fund sponsors. Fund terms are typically long, given the asset class, and commonly last at least ten years.

Investors (limited partners, or LPs) are passive with limited liability. Fund governance is vested in the general partner (GP) or managing member, subject to limited remedies exercisable by LPs. Day-to-day management of fund operations and investment advisory functions may be delegated to a management company (an affiliate of the GP that employs the sponsor's personnel).

Structuring

The simplest venture capital fund structure is a single Delaware-organised entity for all investors. More varied investor and investment profiles may result in additional parallel funds or funds organised in a primary-feeder structure, each across various jurisdictions. There is typically flexibility for funds to create alternative investment vehicles in respect of one or more specific investments for participation by some or all investors as needed for legal, tax, regulatory or similar reasons.

Governing Documentation

Like the private funds industry broadly, venture capital funds are primarily governed by an operating agreement – either a limited partnership agreement or limited liability company agreement – that sets out the fund's economic and governance terms.

Individual investors acquire fund interests pursuant to a subscription agreement, which includes standard representations and warranties, certain disclosures and a questionnaire for self-reported information about the investor's legal, tax and suitability status, such as *"accredited investor"* and *"qualified purchaser"* status.

There may also be an investment management agreement in place to document the payment of the management fee to the management company in exchange for the investment management services it provides to the fund.

Finally, certain investors may request to enter into side letters from the fund to memorialise certain preferential treatment around economics, governance and transparency or other requirements related to their specific legal, regulatory and tax circumstances.

2.2 Fund Economics

The primary forms of economic participation for fund sponsors and their principals include management fees and carried interest. The most common closed-end venture capital fund features are summarised here – although exact economic packages vary depending on a variety of factors, including the fundraising environment,

sponsor maturity, negotiating leverage, investment strategy and fund structure.

Capital Mechanics

Venture capital funds generally employ a commitment/drawdown structure. Investors make capital commitments to the fund, which may be called or *"drawn down"* (as a capital contribution) in one or more instalments over time. The permitted uses for contributed capital typically include new investments, fees and expenses, follow-on investments, and reserves, with the bulk of capital drawn down during the three-to-five-year investment period for new investments and reserves. Venture capital funds also commonly have generous recycling and reinvestment provisions to redeploy capital from investments realised during the life of the fund.

Fees

Management fees are asset-based fees charged throughout the life of a fund. Structures vary widely – although a common model consists of an annual fee (usually 1–3%), charged quarterly, on the basis of capital commitments during the fund's investment period and on the basis of invested/contributed capital thereafter. Fees are typically more important earlier in the life of the fund, as investments are being made and no profits are being realised, and allow the sponsor to cover expenses (including salaries) and maintain operations. In recent years, management fees have become an important source of additional revenue supporting increasing manager enterprise value.

The sponsor and its principals may also receive certain portfolio company remuneration and transaction fees (eg, directors' fees) directly, which are commonly – but not always – offset against management fees.

Carried Interest

The main method of profit sharing in venture capital funds is the allocation of carried interest to the sponsor. With increasing sophistication and size over time, venture capital fund documents have experienced some convergence with the broader private equity funds market, including its distribution-based carried interest structure. As a result, the precise structure of venture capital fund carried interest deals also varies widely – although there are some commonalities. This is particularly the case with regard to the idea of a carried interest *"waterfall"*.

Under the carried interest *"waterfall"*, gains are allocated according to a specified order of priority as between the GP and each LP, with investors typically receiving a return of invested capital and a preferred return (or hurdle return) before the sponsor receives any share of the profits. Owing to the risk-return profile of venture capital funds, carried interest rates tend to be higher than in the private equity industry more broadly, ranging anywhere from 20–30%. Higher rates tend to correspond with more LP-favourable preferred return or hurdle structures before sponsors can earn their full carry rate.

Venture capital funds tend to make distributions only once the entire portfolio is fully realised or once allocated gain has reached a certain threshold, and it is very common practice for distribution timing to be entirely at the sponsor's discretion. However, an increasing number of venture capital funds are starting to follow the private equity distribution-based model and return capital as and when investments are realised.

Investor Protections

Venture capital fund investors are typically locked up for a long duration with no role in the

day-to-day governance of the fund and limited remedies against sponsors. As such, the core investor protections are structural in nature. By way of example, investors rely heavily on economic alignment from capital commitments of the sponsor and exclusivity/deal flow covenants. Management fees may step down over time to guard against perverse incentives from the non-deployment of capital, and the carried interest and distribution structure further protects against the sponsor taking profits before investors have achieved some minimum level of return. Some operating agreements also include specific investment-level restrictions, such as concentration limits and outright prohibitions.

Actual investor remedies vary from fund to fund, but often include the concept of a suspension period wherein new investments may not be made following certain events such as the death, disability or termination of one or more specified key persons, *"cause"*, or a change in control of the sponsor. Suspension may lead to the early termination of the fund's investment period. Some funds have GP removal rights for serious misconduct and others include the right to terminate and wind up the fund entirely.

2.3 Fund Regulation

Regulation of venture capital funds in the USA generally follows the regulation of the broader private funds industry, with some additional exemptions available to venture capital strategies, as described here.

Investment Company Act

Venture capital funds typically rely on exemptions from being considered an investment company under Section 3(c)(1) and/or Section 3(c)(7) of the US Investment Company Act (the *"1940 Act"*) to avoid registration as an investment company thereunder. Both exemptions require that the fund interests not be publicly offered.

Section 3(c)(1) funds must be beneficially owned by no more than 100 persons (or 250 persons if *"venture capital fund"* with no more than USD10 million in aggregate capital contributions and uncalled committed capital), without any independent sophistication requirement. The issue of counting beneficial owners for Section 3(c)(1) purposes is not straightforward, as it may involve looking through certain entities and is subject to *"integration"* with other similar pools of capital under certain circumstances.

Section 3(c)(7) funds have no limitation on the number of beneficial owners. However, all investors must be *"qualified purchasers"* under the 1940 Act, which includes a range of categories of persons deemed financially sophisticated based on the value of *"investments"* owned.

Regulation of Investment Advisers

Venture capital fund sponsors are also subject to regulation under the US Investment Advisers Act of 1940 (the *"Advisers Act"*), typically as an *"exempt reporting adviser"* under Section 203(l) (the *"venture capital funds exemption"*) or Section 203(m) (the *"private fund adviser exemption"*).

Under the venture capital funds exemption, investment advisers that advise solely one or more venture capital funds are exempt from registration as an investment adviser. The definition of *"venture capital fund"* under the Advisers Act is a private fund that demonstrates that it pursues a venture capital strategy, is subject to certain strict limitations on the fund's investment holdings (including leverage), and generally prohibits redemptions.

Under the private fund adviser exemption, an investment adviser that acts solely for one or more *"qualifying private funds"* and manages less than USD150 million of private fund assets is exempt from registration as an investment adviser.

While exempt reporting advisers are not subject to registration as an investment adviser under the Advisers Act, they are still required to make a basic filing on Form ADV with the SEC and are subject to some of the Advisers Act's substantive requirements, including broad anti-fraud provisions, pay-to-play requirements, the requirement to maintain written policies and procedures to prevent the misuse of material non-public information, and record-keeping obligations, as well as individual state law regulation.

Other Regulatory Regimes

Venture capital funds must also offer their interests in compliance with US securities laws, which generally results in their interests being offered to investors under Rule 506(b) of Regulation D (described in **7.1 Securities Offerings**) or – with increasing frequency – by means of general solicitation under Rule 506(c).

Other regulatory schemes applicable to venture capital funds include those relating to the US Securities Exchange Act of 1934 (the *"Exchange Act"*), the US Commodity Exchange Act, the US Employee Retirement Income Security Act of 1974, various AML and privacy laws, and the US Bank Holding Company Act of 1956.

2.4 Particularities

Challenging Fundraising Environment

The private funds industry as a whole was significantly impacted by the unexpectedly persistent high interest rate environment and slowdown in M&A and IPO activity in the USA. This has led to a particularly difficult fundraising environment for venture capital funds, with more established and successful managers receiving coveted allocations from increasingly selective investors facing significant liquidity constraints and over-allocations to private funds. This is likely to persist for a period of time even after interest rates fall and M&A and IPO activity renews once market confidence returns to the USA. In addition, extensive investor diligence and scrutiny over venture capital sponsors is likely to constitute the new normal, as LPs get used to the benefits of increased negotiating leverage in the down market.

Increased Regulatory Scrutiny

While venture capital fund managers have long enjoyed complete or substantial exemption from 1940 Act and Adviser Act regulation, the regulatory landscape has shifted and regulatory scrutiny over the private venture capital industry has been increasing. By way of example, the SEC has demonstrated a willingness in recent years to increase its examination and enforcement activity in respect of exempt reporting advisers. In addition, as venture capital fund sponsors seek to diversify their investment strategies for greater flexibility and attract greater levels of reliable institutional capital, many sponsors have elected to register voluntarily as investment advisers and become subject to the full complement of the Advisers Act regulation.

Structuring Innovations

Venture capital funds comprise a vast range of strategies, life cycles (eg, seed stage or growth stage), and industries. Sponsors take different approaches to investing, with some routinely leading funding rounds and others investing more passively. Some hands-on sponsors are helping to create companies by investing in and alongside accelerators, *"labs"* and incubators,

as well as developing relationships with and taking stakes in founders at the earliest possible stage. This increasing diversity and sophistication should lead to more specialised venture capital fund vehicles, the proliferation of customised accounts and overlapping strategies, evergreen funds and increased interest in asset and portfolio sales across different funds managed by the same sponsor – all of which increase the attendant potential conflicts of interest that need to be managed.

The industry, more broadly, has been exploring new models of holding onto companies for the long term throughout their entire life cycle – from inception through to post-IPO – while providing current opportunities for carry crystallisation and investor liquidity. While these liquidity strategies are not nearly as popular as they have been in the more traditional private equity space – likely due to the comparatively greater flexibility for longer hold periods in venture capital funds as compared to traditional private equity funds and the depressed valuations in recent years – there is a renewed optimism around exploring liquidity solutions in the venture capital space, as evidenced by increasing secondaries transaction volume (including, in particular, large multi-asset continuation vehicle fundraisings) and optimistic fundraisings for dedicated secondaries funds targeting venture capital strategies. These structures include secondaries transactions (such as continuation funds), GP stakes and net asset value (NAV) financing, which recognise the current reality of increased pressure to provide liquidity for LPs who have been struggling to make new allocations (even to successor fund vintages for the same sponsor) because low exit transaction volume has limited their return of capital in recent years.

3. Investments in Venture Capital Portfolio Companies

3.1 Due Diligence

The level of due diligence conducted by venture capital investors in the USA can vary greatly depending on, among other things, the relevant investment round, company valuation and the size of investment as well as the overall interest by potential investors.

Scope

Diligence is typically led by the lead investor in a given investment round, while other investors generally focus on key issues or issues that are specifically relevant to their fund. In early rounds, the main focus is on:

- capitalisation matters, such as the company's capitalisation table, convertible securities, investors' rights agreements, pre-emptive rights, voting agreements and the like, as well as any outstanding indebtedness;
- alignment of the incentives of founders and key employees with those of external stockholders through appropriate employment and equity compensation arrangements; and
- ownership of IP needed to run the business, including patents, licence agreements and IP assignment agreements with founders and employees.

In later rounds, more robust legal and business diligence is conducted, including detailed review of financials, material contracts, employment agreements, litigation and regulatory matters.

When conducting diligence on AI companies, investors may also evaluate whether the technology is truly *"generative AI"* or simply machine learning. Generative AI creates new content (making such technology more valu-

able), while machine learning analyses data for predictions and classifications. This additional diligence could help mitigate the risk of overstating the use of generative AI, also known as *"AI Washing"*, when in fact a company is using less-sophisticated computing or has AI solutions that are not yet fully operational.

Process

Due diligence review customarily begins with a document review process in which the lead investor provides a due diligence request list to the company and, in turn, the company populates a virtual data room with the requested materials. There is often back-and-forth between the company and investor for various follow-up requests based on findings. Diligence sessions may also be scheduled with management and cover topics such as a business overview, the valuation model or regulatory matters.

The overall process typically runs over the course of a couple weeks, but can also take significantly more or less time. Additionally, companies with significant negotiating leverage may impose a limitation on scope of requests or time devoted to the diligence process.

Representations and Warranties

A company's representations and warranties in the transaction's definitive agreements also play a critical role in the due diligence process. A company must disclose any exceptions to its ability to make its representations and warranties in a separate *"disclosure schedule"*, guiding investors to certain material contracts, legal and regulatory issues and the like.

3.2 Process

In the USA, the lead time required to complete a new financing round can vary, but typically takes between two and four weeks to proceed from initial drafts to executed documents. This assumes that a term sheet with key terms is agreed upon in advance and the documentation is based on the US National Venture Capital Association (NVCA) forms, which leads to significantly increased efficiency. If the growth company already has outstanding convertible preferred stock (see **3.3 Investment Structure**), the process can take even less time.

Working With New Investors

Transaction documentation is typically based on the NVCA form documents. Company counsel will ordinarily prepare initial drafts of the documentation – although practice is mixed, particularly when the company is issuing its first series of convertible preferred stock. The company is often required to pay the investors' legal fees in connection with the investment, subject to a cap.

New lead (or *"anchor"*) investors will typically utilise their own legal counsel to negotiate the transaction documentation. Lead investors often engage outside counsel. The second-largest investor may also engage separate counsel, depending on the size of their investment. Smaller investors often leverage their own in-house legal teams, generally follow the terms negotiated by the lead investors, and focus their diligence on any areas of particular focus for their fund or on key areas specific to the deal.

Role of Existing Stockholders

Existing stockholders have a limited role in the new financing round, except as investors in the round and/or for purposes of consenting to the financing. A growth company typically must obtain the consent of existing stockholders to initiate a new financing round, even if the new financing is not senior to the existing financing

in the liquidation preference waterfall (see **3.5 Investor Safeguards**).

Such consent can take multiple forms. In some instances, the holders of a majority of all convertible preferred stock voting together as a single class must approve a new financing round. In other instances, a majority of the convertible preferred stock must approve a new financing round on a series-by-series basis. As a practical matter, the lead investor(s) in the previous financing rounds will usually have board representation and be apprised of the company's fundraising efforts already.

3.3 Investment Structure

Common stock is generally reserved for founders, employees and a limited number of early investors. Venture capital investors and other third-party investors will typically invest through convertible preferred stock and/or other convertible instruments.

Convertible Preferred Stock

The rights associated with convertible preferred stock typically follow the NVCA form documents and are primarily economic or governance-based in nature.

Economic Terms

Key economic terms include:

- conversion rights, typically into common stock at a 1:1 ratio (with an automatic conversion in certain circumstances);
- a liquidation preference, which determines the order of investor payouts resulting from a liquidity event;
- voting rights to vote alongside holders of common stock on an *"as converted"* basis;
- dividend rights, typically in the form of a right to receive the same dividends paid to holders of common stock;
- a right to participate in new security offerings;
- corporate event-based anti-dilution protections, ensuring that holders are not disadvantaged by stock splits, stock dividends or other similar events; and
- price-based anti-dilution protections, often consisting of downward adjustments to the purchase price of the shares previously purchased by preferred stockholders in the event of a down round equity financing.

A handful of these economic terms of are discussed under **3.5 Investor Safeguards**.

Pay-to-play provisions are also occasionally seen. A pay-to-play provision requires investors to participate in subsequent financing rounds on a pro rata basis or else have their existing preferred stock converted to common stock.

Governance Terms

Key governance terms include:

- rights to elect a certain number of board seats; and
- stockholder and director veto rights over certain fundamental corporate actions, such as the issuance of senior and/or pari passu securities, mergers, payment of dividends, stock redemptions and actions adverse to the rights of the convertible preferred stock.

These governance features are discussed under **3.6 Corporate Governance**.

Other Terms

Additional rights that do not fit squarely within the *"economic"* or *"governance"* buckets include:

- drag-along rights, which require investors to participate in a sale of shares approved by a specified threshold of convertible preferred stock and other specified parties;
- a right of first refusal (ROFR) for investors and/or the company to purchase shares of common stock proposed to be sold by certain stockholders (typically the founders and other key holders);
- tag-along or *"co-sale"* rights, which allow investors to participate in a sale of their shares if an ROFR is not fully exercised; and
- registration rights, which allow preferred stockholders to participate in (and, in certain situations, require the company to facilitate) registered offerings of their securities (allowing their securities to be freely sold in the public markets).

These are discussed in **6.1 Investor Exit Rights**.

Other Convertible Instruments

Other convertible instruments, such as convertible notes and SAFE instruments, are commonly used by growth companies in the USA before their first priced equity round. Upon their first priced equity round (sometimes subject to a minimal capital raise requirement), the instruments convert into equity at either a discount to the priced round or subject to a valuation cap.

Investors in these instruments typically include *"friends and family"*, *"angel investors"* and a limited number of venture capitalists that invest in early stage growth companies. Although investors in these convertible instruments do not benefit from the same rights as those given to actual common stockholders or preferred stockholders, large investors may seek information rights, board observer rights or other rights typically reserved for other equity holders.

The SAFE was created by Y Combinator, which maintains three versions of the SAFE for USA companies:

- a discount SAFE;
- a valuation cap SAFE; and
- *"Most Favoured Nation"* (MFN) SAFE, which provides that any better terms granted to a subsequent investor will automatically apply to the SAFE.

There is no standardised form convertible note in the US – although law firms sometimes maintain their own forms.

3.4 Documentation

Growth company financing rounds in the USA typically follow the NVCA form documents. The typical suite of financing documents includes:

- a stock purchase agreement that covers the purchase of stock, sets forth any closing conditions, and includes representations and warranties of the parties;
- a ROFR and co-sale agreement that subjects the sale of stock by certain stockholders to a ROFR in favour of other investors and/or the company and, in the event the proposed stock is not so purchased, permits such investors a right to *"tag along"* in the proposed sale;
- a voting agreement that provides stockholders with the right to designate certain members to the board of directors (*"board designees"*) and the right to *"drag along"* other investors in a sale of the company if specified conditions are met;
- an investors' rights agreement that specifies the rights and privileges granted to stockholders (including information rights, registration rights and pre-emption rights) and specifies any matters requiring the approval of the

preferred stockholders' board designee(s); and
- a certificate of incorporation, or a charter, that:
  (a) defines the rights, preferences, privileges and restrictions of each class and series of stock; and
  (b) typically addresses dilution protections, voting rights, dividend rights, liquidation preferences and preferred stock conversion rights.

The NVCA updates these form documents from time to time, including several notable updates in October 2023.

3.5 Investor Safeguards

There are a number of safeguards built into the NVCA form documents that are utilised to protect venture capital investors from a downside scenario. There are also additional levers that can be built into these safeguards to provide further downside protection. These protections are often influenced by fluctuations in the venture capital market oscillating between investor-friendly conditions and company-friendly conditions.

Pre-Emption Rights

Pre-emption rights permit stockholders to participate in an upcoming financing round in order to preserve their ownership level in the company and avoid dilution caused by new securities being issued. If any stockholder with pre-emption rights chooses not to purchase its full pro rata share of the new securities being issued, the remaining stockholders with pre-emption rights are granted the right to purchase such securities. In the USA, pre-emption rights are commonly only given to the major investors in the company.

Anti-Dilution

Broad-based weighted-average anti-dilution provisions are standard in the USA. These provisions protect preferred stockholders from a down round financing by adjusting the rate at which the preferred stock converts into common stock based on the sale price used in the down round as well as the number of shares sold in the down round. The formula used to determine the conversion rate is based on the number of shares deemed outstanding immediately prior to the down round. For *"broad-based"* provision, the number of shares deemed outstanding includes shares reserved for issuance under outstanding options and warrants.

Narrow-based weighted-average anti-dilution is similar, but excludes shares reserved for issuance under outstanding options and warrants in the number of shares deemed outstanding for purposes of the formula. By including fewer shares in the formula, there is a larger anti-dilution adjustment for the preferred stockholders.

In very rare, distressed situations, preferred stockholders may be able to secure *"full ratchet"* anti-dilution provision, which adjusts the conversion rate solely based on the sale price used in the down round. This results in the largest anti-dilution adjustment for preferred stockholders and is the least favourable outcome for common stockholders (who are not granted the same protection).

Liquidation Preference

Venture capital investors hold their interests in convertible preferred stock, which receives a senior liquidation preference, prioritising payouts to such holders over payouts to common stockholders in the case of a sale or winding-up of the company. *"non-participating liquidation preference"* is most common and provides that

preferred stockholders have a right to receive the higher of:

- an amount equal to the purchase price of their stock; and
- their pro rata share of the proceeds resulting from the liquidity event.

In a distressed situation, and more frequently in recent years as a result of a more challenging fundraising environment, investors are sometimes able to secure a liquidation multiple and/or participation on their liquidation preference. *"2x participating preferred"*, for example, would allow an investor to recoup twice its initial investment and then participate in any distributions made to the common stock pro rata. Participation with the common stock could also be subject to a cap on the overall return the holder may receive in the liquidity event or be *"fully participating"*.

Dividends

Preferred stockholders typically have rights to receive dividends on an *"as converted to common stock"* basis when, as and if paid on the common stock. Variations of these dividend rights are less common, but include a fixed dividend payment required before the company can pay dividends on the common stock and cumulative dividends that accrue at a fixed rate over time.

Upon a sale or winding-up of the company, the holders of convertible preferred stock would be entitled to their liquidation preference plus any declared and/or accrued but unpaid dividends before the common stock is entitled to receive anything. These investor-friendly variations have become slightly more common under recent market conditions.

3.6 Corporate Governance

Investors negotiate for a variety of minority protections that come in the form of stockholder and director approval rights over specified fundamental actions proposed to be taken by the company. Directors (including those designated by a specific investor or group of investors) are subject to fiduciary duties and, as such, must act in a manner they believe is in the best interest of the company and all of its stockholders (and not just in the best interest of the investors that nominated them). As a result, both the company and investors may carefully consider which matters are voted on by investors in their capacity as stockholders as opposed to in their capacity as directors.

Stockholder Approval Rights

Special stockholder approval rights typically require the approval of the holders of either a majority of all convertible preferred stock voting together as a single class or a majority of a specific series of convertible preferred stock.

Actions customarily subject to special stockholder approval include:

- extraordinary transactions, such as mergers and asset sales;
- liquidating, dissolving or winding up the company;
- the issuance of senior and/or pari passu securities;
- amendments to the company's charter in a manner adverse to the outstanding convertible preferred stock; and
- payment of dividends.

Board Designees and Approval Rights

Investors are usually granted the right to designate at least one director (a *"preferred director"*) to the board of directors. This right is typically

held by the holders of a majority of each individual series of convertible preferred stock or by the holders of a majority of all convertible preferred stock voting together as a single class.

Special director approval rights require that specific board actions be approved by the company's board of directors, whereby the vote must include the director(s) designated by the preferred stockholders.

Actions customarily subject to special director approval include:

- incurrences of certain types of indebtedness;
- hiring, terminating or changing compensation of executive officers;
- sales of material technology or intellectual property; and
- entry into material corporate strategic relationships.

Other Considerations

Growth companies also maintain a regular dialogue with their lead investors and often leverage their expertise inside and outside the board room. Advice and input provided by investors can help inform the direction and priorities of management and can also vary by sector. Venture capital funds in the USA that focus on biotech/life sciences companies, for example, are typically *"industry players"* that can offer significant expertise.

3.7 Contractual Protection

Transaction documentation in the USA includes a fairly standardised set of representations and warranties as a result of the widespread use of NVCA forms.

Growth companies provide a robust set of customary representations and warranties relating to, among other things, proper organisation, due authorisation of the transactions, capitalisation, government consents and filings, litigation and other liabilities, IP, material contracts, property, financial statements, tax matters, employee matters, insurance, Committee on Foreign Investment in the United States (CFIUS)-related matters, and valid issuance of shares. Sometimes, industry-specific representations are also included.

Investors also provide a limited set of customary representations and warranties that are primarily designed to help ensure the company's securities are being sold with a proper exemption from US securities law registration, including representations with regard to *"accredited investor"* status, sufficient disclosure of information, and purchasing of shares for the investor's own account.

Closing of a financing is typically conditioned on the accuracy of the representations and warranties, compliance with any pre-closing covenants, execution of other investment documents (such as the voting agreement and investors' rights agreement), and sometimes delivery of an opinion of company counsel. Pre-closing covenants and other undertakings typically only appear when regulatory approval is required, such as CFIUS or antitrust approval.

In the event that closing conditions are not satisfied by one of the parties (eg, if a party breaches its representations or fails to satisfy its pre-closing obligations), the non-breaching party is not required to close the transaction. The non-breaching party may also sue for damages, with monetary damages being the most typical remedy. In the event that the transaction does close, representations and warranties typically survive the closing, and the non-breaching

party may also sue for damages post-closing. In practice, this fact pattern is unusual, as it results in a lawsuit between the company and its stockholder. When a limited survival period is negotiated for general representations and warranties, between six months and two years is common; longer survival periods may be negotiated for specific categories, such as tax representations.

4. Government Inducements

4.1 Subsidy Programmes

Investment in growth companies in the USA is often focused on qualifying for benefits under the *"Qualified Small Business Stock"* (QSBS) regime. This is discussed in further detail in **4.2 Tax Treatment**.

Several states in the USA also offer an angel tax credit, whereby an investor is given a tax credit if they make investments in certain start-up companies. Bills have been proposed to create a federal angel tax credit, but none have been passed.

As discussed in **4.3 Government Endorsement**, there is also a variety of government programmes in the USA that help facilitate equity investment in growth companies without the use of the US tax regime.

4.2 Tax Treatment

Growth companies in the USA are often incentivised to help their investors receive the tax benefits available under the QSBS regime, which is generally available only to early stage companies. Under these rules, individual investors may exclude all or a substantial amount of gain upon the ultimate disposition of QSBS stock.

There are numerous technical requirements to qualify as QSBS, including:

- that the business is organised as *"C"* corporation under the US Internal Revenue Code (the *"US Code"*)
- that the investor acquires the stock at its initial issuance; and
- that at such time the corporation conducts an active business and has less than USD50 million of value in gross assets.

Certain businesses are not eligible for QSBS, including many professional services and banking businesses. Even once stock qualifies as QSBS, additional rules apply to the business as well as transfers involving QSBS that must be considered to ensure QSBS stock retains its status as such.

The favourable benefits available to QSBS are the subject of current political attention and legislative reform proposals.

4.3 Government Endorsement

The US Department of Treasury runs the State Small Business Credit Initiative (SSBCI), which consists of USD10 billion in government funding that is distributed to US states, territories and tribal governments in order to provide capital to small businesses and start-ups. There is a specific programme within the SSBCI for venture capital, whereby the funding is used either:

- to provide capital directly to businesses in the form of equity investments; or
- to provide funding to venture capital firms.

There are also a number of state-by-state programmes in the USA that allocate resources directly to small businesses owned by underserved or under-represented groups, such as

veterans, minorities, women, or people with disabilities. New York, for example, has the Minority- and Women-Owned Business Enterprise Program for businesses owned by women and/or minorities in New York State, and prioritises these businesses for state procurement. Other programmes prioritise specific industries. Government endorsement programmes are the subject of current political attention.

5. Employment Incentives

5.1 General

Growth companies in the USA seek to encourage the long-term commitment of founders and key employees through the issuance of equity awards. Equity awards incentivise employees to remain with the company long enough for their awards to vest and to work diligently to ensure maximum value upon settlement.

5.2 Securities

Equity awards are generally issued with vesting conditions based on the passage of time (usually three to four years, often with a one-year *"cliff"* and monthly or quarterly vesting thereafter) and, in some cases, the achievement of Key Performance Indicators. Typical forms of equity awards in the USA include restricted stock, stock options and restricted stock units (RSUs). Growth companies may also award phantom equity and profits interests.

Restricted Stock

Restricted stock is actual stock subject to vesting conditions – the non-satisfaction of which results in forfeiture of the stock. Restricted stock is generally granted to founders and key employees at the start of a company's development. Restricted stock differs from stock options and RSUs, which are contractual rights to receive/purchase shares upon vesting.

Stock Options

A stock option is a contractual right to purchase stock via payment of an exercise price, which is equal to the fair market value (FMV) of the underlying shares at the time of grant upon vesting. Stock options are generally granted to employees slightly later in the company's development than restricted stock. Companies often issue incentive stock options (ISOs) but may also issue non-qualified stock options (NQSOs) (see **5.3 Taxation of Instruments**).

Restricted Stock Units

An RSU is a contractual right to receive stock upon vesting without payment of an exercise price or otherwise. RSUs are generally awarded to employees later in the company's life cycle when the company's valuation has risen or to address dilution concerns.

Phantom Equity

Phantom equity is a contractual right to receive cash tied to the performance of the company's stock. Phantom equity is generally awarded only in unique situations.

Profits Interests

A profits interest is an equity-like.interest in the future profits and capital appreciation of a company. It is granted to founders and key employees in companies structured as partnerships or limited liability companies. Economically, profits interests function similarly to stock options.

5.3 Taxation of Instruments

When deciding among equity award alternatives, a growth company must consider the tax consequences for employees, including the amount, character (whether ordinary or capital) and tim-

ing of income inclusion as well as the ability to satisfy tax withholding obligations.

Restricted Stock

Generally, restricted stock is not taxed at grant and is taxed at ordinary income rates on the FMV at vesting (minus any amount paid for the shares). These amounts are generally subject to tax withholding. Employees may have difficulty satisfying these tax obligations, given that the stock is likely illiquid and the FMV may have increased. To avoid this consequence, employees frequently make an election under Section 83(b) of the US Code to be taxed at ordinary income rates on the FMV (minus any amount paid for the shares) at the time of grant. Capital gains rates apply upon disposition of the stock. If, however, an employee forfeits the restricted shares following a Section 83(b) election, the taxes paid may not be recovered and a capital loss may be unavailable. To be effective, a Section 83(b) election must be made within 30 days of the grant date.

NQSOs and RSUs

NQSOs and RSUs are not taxed at grant. NQSOs are taxed at ordinary income rates at exercise on the *"spread"* between the exercise price and the FMV. Similarly, RSUs are taxed at ordinary income rates at settlement based on the FMV. These amounts are subject to tax withholding. Capital gains rates apply upon disposition of the stock.

Like restricted stock, NQSOs and RSUs present issues for employees with limited liquidity to satisfy these tax obligations. Employees often hold NQSOs until a liquidity event (such as an IPO or M&A transaction). Growth companies often award double-trigger RSUs, which are subject to time-based vesting conditions plus a requirement that a liquidity event occurs within a certain period. If properly structured (including with respect to Section 409A of the US Code), taxation is postponed until the liquidity event.

ISOs

ISOs generally are not taxed at grant or at exercise. If the shares are held until the later of two years after grant or one year after exercise, the eventual disposition is taxed at capital gains rates. If these holding periods are not met (a *"disqualifying disposition"*), ISOs are taxed at ordinary rates on the spread at the time of exercise.

ISOs also present concerns under the alternative minimum tax (AMT), to which high-income individuals such as founders and key employees may be subject. Unlike in the regular tax system, AMT does not exclude an option's spread at exercise from income. AMT may also raise issues upon a disqualifying disposition, particularly where such disposition occurs following the year of exercise.

Phantom Equity

Phantom equity awards are taxed at ordinary income rates when paid.

5.4 Implementation

Equity Pool

Venture capital investors generally expect the growth companies they invest in to increase or *"refresh"* the size of their employee equity incentive pool at the time they invest. This becomes a key topic of negotiation because it is ultimately a question of company valuation.

Investors in US growth companies expect existing shareholders in the company to bear the dilution caused by increasing the size of the equity incentive pool. As a result, investors are motivated to have the equity incentive pool be

as large as possible in order to limit their risk of being diluted at a later point in time. Changes to the equity incentive pool often require approval of investors and so founders are motivated to have the incentive pool accurately reflect their hiring needs before the next equity financing, but nothing more (given that they and other existing shareholders are ultimately the ones being diluted).

Ultimately, an equity incentive pool equal to approximately 10–20% of the fully diluted post-money valuation of an early stage growth company is typical.

Founders' Stock

Investors may also demand that any stock held by the company's founders that is not subject to vesting prior to their investment be subjected to a reverse vesting schedule (usually between three and four years, often with a one-year *"cliff"* and monthly or quarterly vesting thereafter) at the time of their investment. Under this arrangement, founders continue to hold their stock, but lose any unvested shares if they leave the company before becoming fully vested.

6. Exits

6.1 Investor Exit Rights

There are a handful of contractual exit rights and restrictions that are built into the NVCA form documents in order to provide some guardrails around secondary sales as well as facilitate exit opportunities that are supported by a critical mass of the existing stockholder base. In the recent, challenging exit environment, investors are even more focused on company growth strategies and exit plans (if any). However, the industry has not yet seen significant shifts in negotiated exit rights.

ROFR and Transfer Restrictions

Founders and other key holders of common stock are typically only permitted to sell their shares to a third party if they first provide the company and/or preferred stockholders with an ROFR to purchase the shares proposed to be transferred. Sometimes this ROFR applies with regard to proposed sales by preferred stockholders as well. The company generally has the right to exercise the ROFR first and, if it does not exercise its right with regard to all of the shares proposed to be sold, the preferred stockholders have a right to purchase the remaining shares.

In the event that any preferred stockholders do not elect to exercise their right in full, the participating (purchasing) stockholders have the right to purchase the additional shares. If the company and preferred stockholders do not collectively exercise their ROFR rights with regard to all of the shares proposed to be sold, then all of the subject shares may be sold to the third party (subject to any tag-along rights, as described later in this section).

There are customary exceptions that generally apply to the application of the ROFR, including for estate planning purposes.

Sometimes, growth companies also subject all of their common stock – or both preferred stock and common stock – to blanket transfer restrictions in their by-laws. In the case of a blanket transfer restriction, customary exceptions will generally apply, including for estate planning purposes. There may also be a carve-out for transfers first subject to an ROFR in favour of the company.

Tag-Along/Co-Sale Rights

If an ROFR is not exercised in full by the company and/or preferred stockholders, preferred

stockholders are typically granted a right to participate – or *"tag along"* in the proposed sale pro rata.

Drag-Along Rights

In the case of *"sale of the company"* that is approved by a specified set of parties (typically, the holders of a majority of convertible preferred stock, the holders of a majority of common stock held by certain key individuals, and the board of directors), the remaining stockholders are usually obligated to vote in favour of the transaction. *"sale of the company"* typically includes a sale of at least 50% of the outstanding voting power of the company, a merger, a sale of all or substantially all of the company's assets or another similar transaction resulting in the change of control of the company.

Registration Rights

Preferred stockholders are also typically granted *"registration rights"*, which allow stockholders to cause the company to register their shares for public resale pursuant to a registration statement. These registration rights take a few different forms. *"Demand"* registration rights give stockholders the right to compel the company to register their securities for public resale. *"Shelf"* registration rights give stockholders the ability to demand that the company file a registration statement to register their securities for sale on a delayed or continuous basis once the company's shares are already publicly traded. *"Piggyback"* registration rights give stockholders the right to register their securities alongside either the company or other holders that initiate a registration of securities.

6.2 IPO Exits

IPO exits are usually driven by existing investor demand for liquidity or perception of access to capital in the public markets as compared to the private markets. An IPO is the most common route for companies in the USA to become publicly traded. For growth companies that have no immediate need for capital, a direct listing of existing investors' securities (with no primary issuance by the company) is also an option. A de-SPAC transaction – whereby a private company becomes public through a merger with an existing publicly traded special purpose acquisition company (SPAC) – is a third alternative for exiting into the public markets; however, this path has fallen out of favour in recent years.

The Nasdaq and the NYSE are the primary listing venues in the USA. Both exchanges have various requirements that must be satisfied in order to qualify for trading, including financial, liquidity, reporting and governance related requirements, some of which overlap with SEC requirements. Accommodations are available for foreign private issuers listing in the USA and often allow such issuers to follow home country governance requirements in lieu of the requirements of the relevant exchange.

6.3 Pre-IPO Liquidity

While pre-IPO investors and employees with stock have generally committed their capital and/or equity awards to the company until an eventual liquidity event, there are various pathways that may be available to liquidate their position prior to such event. Particularly as IPO and M&A activity is constrained, pre-IPO liquidity options have become an increasingly vital component of the venture capital ecosystem.

Liquidity Options

Secondary transactions are often the only viable exit strategy for pre-IPO investors and for long-time employees looking to cash out their equity. In addition to privately brokered sales, digital trading platforms are growing in popular-

ity. Some of the more prominent digital trading platforms used for trading private securities in the USA include EquityZen, Forge Global and the Nasdaq Private Market.

Tender offers are another, more structured option.

Corporate repurchases, also known as share buybacks, are a type of tender offer in which a company offers to repurchase shares from its current stockholders. This type of tender offer can be advantageous to a growth company looking to provide liquidity to its employees or stockholders and buy back shares as a means of *"cleaning up"* its cap table, particularly if there is a large number of current (or former) employee stockholders who hold a small number of shares.

Third-party investors may also conduct tender offers as a means to purchase equity from existing stockholders. Company-facilitated third-party tender offers have also become more prevalent, particularly as companies seek to respond to existing stockholders' desire to monetise on what is otherwise desirable private company stock. In the case of a company-facilitated third-party tender offer, the company may help pool interest from multiple existing and/or potential new investors in order to facilitate the third-party tender offer process.

Regulatory Considerations

Tender offers and secondary sales need to comply with US securities laws, in addition to any transfer restrictions imposed by the company itself.

US securities law requires that all offers and sales of securities in the USA – including secondary sales by existing investors – be registered with the SEC, unless an exemption applies. The most common exemptions for secondary sale transactions fall under Rule 144 and Section 4(a)(7) of the US Securities Act of 1933 (the *"Securities Act"*) and *"Section 4(1 1/2)"*.

Rule 144 provides a safe harbour that allows the public resale of restricted securities (securities obtained through unregistered offerings) and control securities (securities held by affiliates of a company) if the offering complies with certain conditions. Section 4(a)(7) is another codified exemption that allows for the private resale of securities specifically to accredited investors. *"Section 4(1 1/2)"* resales, unlike Rule 144 and Section 4(a)(7), are not codified within the US securities laws. However, *"Section 4(1 1/2)"* resales are a commonly used method developed within the US market to facilitate legally compliant resales of securities without formal registration with the SEC.

Private tender offers in the USA, whether initiated by the company or a third-party, must also adhere to several technical requirements under Section 14(e) of the Exchange Act, including:

- that the offer stay open for at least 20 business days;
- that the offeree make no material misstatements or omissions in the context of the tender offer; and
- that prompt payment be made after the tender offer closes.*"Tender offer"* is not a defined term under US securities laws. Instead, it is a determination based on specific facts and circumstances, and takes into account factors such as a solicitation for a substantial percentage of the company's stock, as well as a fixed price and a limited duration offer.

7. Regulation

7.1 Securities Offerings

In the USA, all companies must comply with US securities laws. The Securities Act requires all securities offerings to be registered with the SEC unless there is an applicable exemption for such offering. One such exemption is Section 4(a)(2) of the Securities Act, which exempts the registration of securities that will not be offered to the public (also known as *"private placement"*). The exemption is intended to apply to sales to a limited number of sophisticated investors who are presumed able to fend for themselves.

Regulation D was adopted under Section 4(a)(2) as a formal safe harbour from securities registration. There are various rules under Regulation D that issuers may rely on for their private offerings, but the most commonly used exemption is Rule 506. Under Rule 506(b), companies can raise an unlimited amount of proceeds through sales to an unlimited number of accredited investors and up to 35 non-accredited investors, so long as they do not make any general solicitations, advertise or market the sale of their securities. Rule 506(c) allows companies to advertise in connection with their securities offering, but requires the company to take reasonable steps to verify the accredited investor status of participating investors. In March 2025, the SEC issued a no-action letter and updated its Compliance and Disclosure Interpretations to provide guidance on the application of minimum investment amounts as a factor in determining whether an issuer has satisfied the requirement to *"take reasonable steps"* to verify a purchaser's accredited investor status under Rule 506(c). Specifically, if (i) the purchaser agrees to make a minimum investment of USD200,000 (in the case of a natural person) or USD1 million (in the case of an entity), (ii) the purchaser provides certain representations (eg, that it is an accredited investor) and (iii) the issuer does not have actual knowledge of any facts indicating that the purchaser's representations were untrue, then the issuer can reasonably conclude that it has satisfied the *"reasonable steps"* requirement. Companies that offer securities pursuant to Regulation D are required to file a Form D with the SEC within 15 days following the first sale. Form D requires information such as the identity of the issuer, the type of offering, the total offering amount and the exemption(s) being relied upon.

Rule 701 under the Securities Act also provides a safe harbour from registration in the event that a private company grants equity securities to its employees pursuant to a benefit plan or other compensation agreement. To be able to rely on Rule 701, a company must itself grant the securities to its employees and must not be subject to reporting requirements under US securities laws.

7.2 Restrictions

CFIUS

The Committee on Foreign Investment in the United States (CFIUS) is authorised to review certain transactions involving foreign investment in the USA, so as to determine the effect of such transactions on US national security. If CFIUS identifies a risk to US national security arising from a transaction, it may negotiate or impose mitigation measures or – in rare cases – recommend that the US President prohibit the transaction.

CFIUS has the authority to review:

- any transaction that could result in a foreign person controlling a US business;
- certain non-controlling but non-passive investments by foreign persons in US busi-

nesses that deal with critical technologies, critical infrastructure or sensitive personal data (*"TID US Businesses"*) and
- certain transactions involving real estate in the USA located within a specified distance of certain airports, maritime ports or sensitive US government facilities.

Certain transactions involving a TID US Business must be notified to CFIUS at least 30 days prior to the completion date of the transaction. Transactions may also be submitted to CFIUS voluntarily in order to obtain a CFIUS *"safe harbour"*, which provides greater certainty that the US government will not impose mitigation measures or force the foreign investor to divest its interest in the US business in the future.

There is no revenue or turnover threshold for CFIUS review. CFIUS may review any transaction within its jurisdiction, regardless of the value of the transaction. As a result, CFIUS can – and regularly does – review venture capital transactions and other transactions involving early stage companies.

Other Potential Restrictions

Depending on the industry in which a foreign venture capital investor is investing, in addition to CFIUS there may also be industry-specific regulatory reviews or requirements arising at the US federal or state levels. Examples of targets that may implicate such reviews or requirements include entities operating in the telecommunications and financial services sectors, as well as companies that provide defence-related products or services, among others.

Trends and Developments

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Gibbons P.C. is a full-service law firm based in Newark, New Jersey, since 1926. It has approximately 200 attorneys, more than 15 of whom make up the venture capital and emerging companies team. In addition to its Newark headquarters, the firm has offices in Manhattan; Trenton and Red Bank, New Jersey; Philadelphia; Wilmington, Delaware; Washington, DC; and West Palm Beach. Gibbons represents venture capital firms and other private equity investors in fund formation and portfolio investments, and regarding issues throughout the investment cycle. It has represented an array of investors, including insurance companies and public pension fund private investors, in direct and secondary investments in private equity, venture capital and real estate funds. The attorneys negotiate, structure and close venture capital financings, joint ventures and strategic alliances; help with business plans, organisational structures and investor presentations; and provide the full range of corporate services required by emerging companies as they mature.

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Frank Cannone is corporate group chair at Gibbons, and his practice focuses on M&A, private equity, early-stage and emerging growth companies, and corporate and securities law. He has extensive experience in representing clients regarding public and private capital raising, private equity, M&A (in middle-market transactions), cross-border transactions, venture capital and other early-stage transactions. Frank is a member of the New Jersey, New York and Pennsylvania Bar Associations; Board of Advisors, Association of Corporate Growth; Board of Visitors, Seton Hall University School of Law; and Co-Chair, Board of Advisors, Seton Hall University Stillman School Center for Entrepreneurial Studies.

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Thomas Rezach is a corporate group associate at Gibbons and has represented emerging companies and venture capital funds in equity finance, debt finance and general corporate matters, and advised angel investors and family offices, among others, regarding their investments in early-stage growth companies. He has also assisted real estate developers in real estate financing transactions. Thomas is skilled in drafting and negotiating a wide range of commercial transaction and financing agreements, as well as certificates of incorporation, side letters, engagement letters, waivers and more. He is also proficient in drafting and reviewing formation/government documents, due diligence memoranda and SEC filing documents and proxy materials.

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The Venture Capital/Emerging Companies Market in the USA: an Introduction

General observations

The venture capital (VC) market remains complex and dynamic, with there being some hope that it is set to grow significantly in 2025. As in previous years, founders and investors will continue to face numerous challenges. However, understanding the latest market trends and developments may increase the probability of success for all parties involved.

The venture capital landscape in 2024 was a tale of two contrasting developments, marked by both significant growth and large uncertainty. Investments surged in Q2 2024, reaching a peak of USD94 billion, representing a 5% increase from Q1. However, this growth ceased and plummeted in Q3, which saw a 16% decrease from Q2. Global technological innovation and macroeconomic trends strongly influenced the volatile venture capital market trends shown by these figures. With the ongoing development of artificial intelligence (AI), it is likely that the global VC market will continue to navigate these dual forces in the coming years.

The pace of financing transactions in 2024 was distinctively slow when compared to the plethora of oversubscribed rounds from the pandemic years. However, the distribution of VC investments revealed certain trends in 2024 that resulted in an upswing in VC activity surrounding start-ups. Compared to 2023, seed transaction sizes increased by 35%, while early-stage investments grew by 14%. This activity shows that investors are willing to back innovative ideas and promising start-ups from an early stage.

With regard to late-stage financings, however, 2024 initially experienced decreases in the early quarters. Late-stage financings finished strong, however, as companies returned to market to raise new financings. In line with these trends, the time between rounds for all series hit decade highs in 2024, with the Series C and Series D+ rounds passing two years from the date of previous investment rounds. Despite the bounce-back, late-stage deal activity declined for a third consecutive year.

The bulk of *"deal value"* in 2024 was dominated by AI-backed companies, which were the primary drivers of increasing deal sizes and valuations in 2024. Out of the USD74.6 billion in deal value generated in Q4 2024, 43.2% can be attributed to the five largest deals (46.4% of 2024's deal value consisted of AI-backed companies, including these top five deals in Q4). Furthermore, looking at deals for USD500 million or greater, 15 deals comprised 54.4% of Q4's deal value. These numbers show two things:

- the venture capital landscape has become quite concentrated (and should continue to be in 2025); and
- the presence of AI-backed companies could be providing *"false"* sense of growth in the market.

The number of *"unique"* investors in this space remains higher than pre-pandemic. Whether this is because of promising technology or investors being influenced by a fear of missing the next *"big"* technology wave, AI dominated the narrative in 2024 and will likely continue to do so in 2025.

Most venture-backed start-ups will need to raise capital in 2025. Generative AI and machine learning businesses are poised to continue to transform various industries by offering new solutions to operational processes. As shown in the figures above, AI has rapidly become business essen-

tial and is driving the start-up and VC markets in early 2025. With macroeconomic uncertainty in 2025, it will likely take time for deal-making activity to ramp back up. When it does, however, these AI and machine learning-based companies are expected to lead the charge.

Current "Hot" Topics

Financial challenges for emerging companies and market outlook in 2025

A major concern in 2024 was the significant drop-off in start-ups that successfully raised funding after securing at least USD1 million in seed rounds. The data, as mentioned above, suggests that this was caused by a more demanding growth trajectory required to secure Series A funding.

As interest rates remained high in 2024 (and continue at elevated levels at least for the first half of 2025), the fundraising environment will most likely remain challenging, as investors continue to be selective, investing primarily in proven business models and market trends and snubbing not yet profitable growth companies.

However, even those companies that successfully raised new capital in 2024 were often faced with deteriorating financing conditions from investors; for example, the number of down rounds remained elevated from 2023 through 2024, as many companies that raised funds in 2021 and 2022 were coming back to market. Down round financing deals often come with more complex terms designed to protect the new investors. The preferential terms for the new investors – which may include more preferred shares, transfer of company control to preferred directors or higher liquidation preferences – harbour considerable potential for conflicts with common stockholders, which the founders will have to navigate.

Emerging companies that are shut out of equity funding opportunities or that want to avoid down round financings are faced with the choice of preserving capital by cutting costs or seeking other non-traditional sources of financing like venture debt, revenue-based financing or investments from major customers, suppliers or other interest groups. These alternative funding sources can bridge the gap until the broader financing conditions are expected to improve in the course of 2025.

For this to occur, more large exits will need to take place at a healthier pace. Currently, there are more companies valued at USD500 million or more than ever before; however, new investments from limited partners are becoming scarcer. Changes at the Federal Trade Commission are expected to remove certain barriers to acquisitions, and rate cuts are also expected later in 2025. However, deal-making figures do not yet signal material increases in activity. Despite this, there remains some optimism that 2025 may see an increase in deal activity.

The 2024 election

As a result of the 2024 presidential election and control of both the US Senate and Congress going to the Republican Party in early 2025, there is an expectation that US businesses will face less federal regulation and lower taxes, which could boost economic growth and support a resurgence in deal volume.

The new administration has also recently implemented numerous new tariffs and is engaging in a general overhaul of US trade policies. While certain tariffs and policies could lead to a resurgence of inflation, impact supply chains and adversely affect relationships with trading nations, tariffs could lead to more domestic involvement in US manufacturing and other

affected sectors. Focusing on inflation specifically, any slowdown in progress toward lowering inflation could affect the optimism for lowered interest rates, impacting valuations in advance of funding rounds.

The continued rise of AI and generative AI

As mentioned herein, AI was a driving factor in the venture market's resurgence in Q4 2024. As we move into 2025, this is expected to rise as generative AI companies look to push into the realm of what is becoming known as *"System 2"*, emphasising reasoning-based responses during inference rather than pulling information from models for quick responses (the method relied on by ChatGPT, for example). 2025 will surely see the rise of these reasoning-based models, leveraging advanced capabilities to enable complex problem-solving across many major industries.

In early 2025, OpenAI and Google are developing and stabilising models to pave the way for further advancement in this area. This is a crucial change as it relates to venture capitalists, as it will lead to a change in methodology related to companies into which venture capitalists will seek to deploy capital.

US Corporate Transparency Act reporting regulations

The Corporate Transparency Act (CTA) came into effect in January 2024 and created an obligation for domestic entities and foreign entities that are registered to do business in the United States, unless exempt, to report beneficial ownership information (BOI) to the Financial Crimes Enforcement Network (FinCEN), a branch of the US Department of the Treasury. The reporting obligations serve to combat fraud, drug trafficking, corruption, tax evasion, organised crime or other illicit activities.

Because many emerging companies will not meet the exemption requirements under the CTA and will have to obtain information from their investors to meet the reporting obligations, they are advised to begin assessing their reporting obligations early, and investors will want to ensure that companies in which they invest comply with the CTA.

The CTA is currently the subject of various legal challenges, and the filing deadline has been pushed back several times already. On 27 February 2025, FinCEN announced that it will not impose fines, penalties or enforcement actions against any companies for failing to file or update BOI reports required under the CTA. It is unclear at this point whether FinCEN will issue any new rules about filing deadlines or reporting requirements, with the Treasury Department already announcing that it will not take enforcement action against Americans or domestic companies who fail to file ownership information under the law. Regardless, emerging companies should pay close attention to the CTA developments to ensure compliance.

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