Skadden

Digital Deals — Navigating CMA Scrutiny

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The U.K. Competition & Markets Authority (CMA), which is on the cusp of becoming an independent merger regulator post-Brexit, is already known for its readiness to investigate global digital deals, issue freezing orders and apply future-gazing theories of harm based on long-term horizons (five or more years). The CMA's 2019 Lear Report recommended using merger control more aggressively to intervene in digital markets, and these recommendations have been taken up in recent consultations on updates to its mergers guidance documents.

In a webinar on 19 November 2020, Skadden antitrust attorneys **Bill Batchelor**, **Ingrid Vandenborre** and **Aurora Luoma**; CEO of Fingleton and former CEO of the CMA **John Fingleton**; and vice president of Charles River Associates and former CMA director of Economics **Matthew Bennett** discussed how to navigate the CMA's approaches in reviewing digital deals, including:

- the CMA's current policy position on tech deals and which transactions catch their attention;
- navigating the CMA's hold separate orders in digital businesses;
- building, buying, partnering and countering claims of competition harm;
- addressing CMA prospective and dynamic theories of harm; and
- addressing complexity in digital remedies beyond the U.K.

Ms. Vandenborre introduced the webinar by recalling that practitioners have seen the CMA take a more interventionist approach, more readily adopting dynamic theories of harm and asserting jurisdiction over mergers in digital markets. This can be framed within wider political shifts as the U.K. gears up for Brexit, with the CMA consulting on updates to its mergers guidance, the government commissioning a further report on the competition regime and, if that were not enough, the government entirely revamping its foreign investment regime with a new mandatory notification system for deals across a swath of U.K. industry sectors.

The CMA's Current Policy on Tech Deals

Mr. Fingleton outlined the background to this increased activity. The Lear Report evaluated past merger decisions by the CMA such as Facebook/Instagram and concluded that these "may have represented missed opportunities for the emergence of challengers to the market incumbents but have also likely resulted in efficiencies". This was echoed in the Furman Report, which advocated a legal framework to "better stop digital mergers that are likely to damage future competition, innovation and consumer choice". But how is this unfolding?

First, the CMA's present CEO, Andrea Coscelli, has been vocal in calling for investigations of tech sector deals and what are perceived as "killer acquisitions". In addition to recent decisions, the draft CMA Merger Guidelines proposals published last week freely quote from Furman and Lear, particularly the call to "accept more uncertainty" when assessing digital markets.

Second, the rate of deals failing at Phase 2 is startling. The Phase 2 process originally was intended to bring in fresh pairs of eyes: senior officials drawn from business, private practice or specialist regulators, who would temper wilder theories of harm with business realism. There may be a question as to whether more fanciful theories of harm are being sufficiently eliminated early enough in the Phase 1 process.

Third, there is limited judicial accountability. The CMA is a proudly evidenced-based organisation and must prove each case on the merits. But there is no merits review on appeal. Rather, litigants must show the CMA acted irrationally, a hard standard to succeed on.

Mr. Bennett explained that there also has been a clear shift in policy towards a greater willingness to look at potential theories of harm, evidenced in the draft Merger Guidelines proposals, which picked up on three "new" theories of harm:

- the incumbent buying potential entrants (killer acquisitions);
- an incumbent that would have entered into an area where the entrant is active but would no longer do so post-merger (reverse killer acquisitions); and
- the idea that both merging parties could be active in nascent markets in the future (competition in innovation).

At the same time, there is more skepticism by the CMA in viewing entry by third parties as a solution to clear mergers. The combination of the shift in policy and the increased skepticism has resulted in significantly more intervention by the CMA.

Ms. Luoma picked up on the jurisdictional test and explained that small tech deals that would rarely meet the GBP 70 million threshold are often captured by the 25% "share of supply" test, seen by the CMA as the "gateway" to review these mergers. The latest guidance makes clear the CMA considers it has broad discretion in this respect. The first question should therefore be, "Will the CMA want to look at this deal?"

The CMA also actively monitors deal activity in the press. The CMA's Mergers Intelligence Committee is most likely to "call in" transactions with, for instance, (i) high valuation compared to the standalone asset value; (ii) a perceived incumbent acquirer; and/or (iii) the involvement of a nascent technology, dynamic or disrupting sector. If any of these issues appear early on, it makes sense to start frontloading and developing a strategy.

Ms. Vandenborre agreed. She said that it is important to understand the CMA's hot buttons and look at both the "static" and "dynamic" positions. Can this be seen as buying out a nascent rival or most aggressive future threat? Will the deal price tag for a target with zero or limited revenues suggest ulterior motives to the regulator? Do internal documents throw up red flags? These potential issues do not necessarily require a rush to file. But the CMA risk should be anticipated in the deal documents. Where there is an obvious "call in" risk, the buyer will want a condition precedent.

Key Takeaways

The merits story needs to be well advanced ahead of signing. Vet your internal documents for issues that may draw attention. Be prepared to include additional context to make sure the documents present a comprehensive and accurate picture. For example include any assumptions that may be implicit in relation to anticipated market growth, and specify whether a forecast is considered to be highly likely or involve an aggressive scenario. Train your corporate development team on what the CMA looks out for, such as deal valuation and statements about market developments.

In this respect it is important to underscore that internal documents that are consistent with and help to develop a strong narrative can be very powerful in highlighting procompetitive implications of a transaction. There is a clear role for not only analysing, but also effectively narrating, procompetitive factors in internal material early on.

Hold Separate Orders

Mr. Batchelor spoke to the CMA's Initial Enforcement Orders (IEOs), essentially hold-separates that enable the CMA to preserve the status quo and prevent a "scrambling of the eggs" by the business integrating. These orders have become increasingly onerous — they are much stricter than gun-jumping rules in the EU and typically apply globally in the first instance.

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A few weeks ago, the Competition Appeals Tribunal (CAT) heard Facebook criticising the CMA for placing "enormous and unjustified" constraints on its business by refusing to alter the terms of a freeze order while the regulator probes Facebook's Giphy acquisition. Facebook's lawyers asked the CAT, "Facebook has an office in Taguig in the Philippines … Why is it any of the CMA's business who Facebook hires and fires there?" The CAT nonetheless upheld the CMA's decision. The global IEO is therefore standard to prevent preemptive action.

While the voluntary nature of the U.K. merger control regime means the parties can sign and close without approval, parties in the tech space should be wary of the burden of the IEO during potentially drawn-out engagements with the CMA.

Building, Buying, Partnering and Countering Claims of Competition Harm

Mr. Fingleton outlined that the first challenge in tech deals is the counterfactual. In traditional industries, premerger conditions are considered to be the status quo. But dynamic sectors do not stand still. This is at the heart of the CMA's new approach. It asks the questions, absent the deal, would the target have grown into a rival of the acquirer? Or does the acquisition mean the acquirer will bury its plans to enter the market?

Mr. Bennett expanded on the topic, stating that the acquirer's valuation of the target is becoming increasingly important evidentially. The CMA will look closely at the valuation (and supporting documents) behind the bidding price as a potential indicator of a killer acquisition. However, to date, when valuations have been found to have a benign or procompetitive rationale, the CMA has not placed a lot of weight on them.

Dynamic counterfactuals and the CMA's theories of harm are generally coherent economic theories. The real problem is that they rely on both the acquirer and the target's incentives with regards to entry — something that is difficult to support with evidence. This means the CMA relies heavily on internal documents as a means to investigate the incentives, which explains in part why internal documents have become so important, even in Phase 1 mergers.

Ms. Luoma outlined examples of the CMA's recent approach to understanding how the market might develop absent the merger, noting the CMA on its own terms is prepared to accept greater uncertainty. Different themes are apparent: prospects of "reentry"; "tech omnipotence" and ability/incentive to enter; and "infinite deep pockets" for innovation competition even absent the merger.

Mr. Batchelor agreed that to an extent this reflects "big tech syndrome", *i.e.*, the CMA's belief in the omnipotence of big tech companies. However, big tech is constrained by similar limitations as other industries. A key practical risk is the CMA's weighing of internal documents. Those will commonly use a "build, buy, partner" framework to evaluate the merits of a deal. But these statements can be potentially damaging in the context of merger review. The CMA may say that a "build" timeline of two to three years is evidence the acquirer would enter the market itself, and so by buying the target there is a reduction of competition. Parties should anticipate these concerns when drawing up their deal evaluations and be prepared to identify and explain these statements when considering a strategy for the CMA.

Addressing CMA Prospective and Dynamic Theories of Harm

Mr. Fingleton said that the CMA's analytical lens has extended well beyond classical antitrust analysis to deploy more speculative theories, such as whether ostensibly outsized valuations mask anticompetitive intent; whether currently nascent competitors might, in fact, be future heavyweights; or whether alternative buyers generate more competitive outcomes.

Ms. Vandenborre gave further examples demonstrating that while a deal may show low market shares currently on a static assessment, a dynamic assessment may present a different story. The challenge for the CMA is finding a way to conduct a forward evaluation of highly complex, dynamic markets. The CMA does not have its own technical experts, and empirical data only gives a snapshot. So the CMA relies — some might say too heavily — on internal documents. This heavy reliance on internal documents to the exclusion of empirical analysis can lead to skewed outcomes.

Mr. Bennett agreed and indicated that what is clear is that a hairsbreadth can separate a Phase 2 prohibition from clearance. It is hard to prove or disprove these theories of harm based on economic evidence, and this puts emphasis on starting early and understanding the key documents and what they say about these potential theories of harm. Among the worst things that can happen for a deal is to have a document that appears halfway through Phase 1 that contradicts the parties' narrative or that can be misconstrued by the CMA.

Ms. Luoma concluded this section by noting the high threshold for successfully challenging CMA merger decisions. CMA findings on core substantive issues, such as market definition or closeness of competition — sometimes based on speculative economic theory — will survive challenge unless any of the findings are found to be "irrational". That said, as the CMA embraces more complex theories, there are limited signs the CAT may engage more.

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Remedies

Mr. Fingleton observed that Andrea Coscelli has indicated the CMA takes a tough stance on remedies in digital markets. Mr. Batchelor agreed, highlighting a reluctance to accept remedies in particular where parties have sought to carve out a package from their wider offering, most recently in *FNZ/GBST*. However, there is some cause for optimism. In *Broadway/ION*, the CMA approved a "reverse" carve-out, amounting to the sale of the entire share capital of Broadway. The CMA typically reviews a reverse carve out as reducing the composition risk, although in *FNZ* it rejected the parties' request, as it raised issues of financial resilience needed for the divested business to have a proportionate cost base.

The CMA's scepticism about complex remedies should form an early part of the antitrust assessment, particularly as buyers of the overlap asset may consider the business entirely viable, even if the CMA does not or perceives intolerable integration risks. Rather than risk a prohibition, it may be appropriate to agree with the seller to hive off part of the asset to an alternative purchaser. If that is not possible, then having a fully thought-through remedies package that addresses dis-engagement risk to a prepackaged divestment buyer will be essential.