

# DIGITAL AND COMPETITION SHOULD THE RULES BE CHANGED?

**WEBINARS** From March 9th to March 12th, 2021



## **Digital and competition: Should the rules be changed?**

#4 Business angels, VC and CVC:

What role for antitrust and regulatory policy?

*Friday 12 March 2021*

*Interview with Daniel Sokol (Levin College of Law - University of Florida and White & Case), by Nicolas Petit (European University Institute)\**



*Daniel Sokol (Professor of Law, Levin College of Law - University of Florida and Senior Advisor, White & Case, Washington D.C./Miami) has been interviewed by Nicolas Petit (Professor of European Competition Law, European University Institute, Florence) in anticipation of the second edition of the **Digital and Competition Conference “Should the rules be changed?”** to be held online with a series of 4 webinars from March 9th to 12th, 2021.*

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## **Nicolas Petit: Why is the VC perspective on competition and innovation relevant for antitrust analysis?**

**Daniel Sokol:** I think that the VC perspective (and I also will include CVC perspective) is very important. While antitrust authorities have dealt with start-up acquisitions for years, this has become increasingly high profile from an antitrust perspective. I first wrote about the motivations for such acquisitions and how to think about antitrust analysis in this area in [an article that was published in 2018](#) (which on this topic seems like a lifetime ago – and before the Cunningham et al paper [Killer Acquisitions](#) came out in working paper form). In that article, I cautioned “*merger policy that would unduly restrict large tech firms from undertaking acquisitions [...] would hurt incentives for innovation in the economy by chilling business formation in start-ups.*”

Let’s begin with a basic premise. It is reasonable for agencies to want to make sure that they are identifying and investigating properly nascent acquisitions. The Cunningham article deserves accolades for identifying a mechanism in pharma that may lead to potential anti-competitive harm. They identified the risk that an originator (branded pharmaceutical company) acquires a start-up company with a pipeline product with the intention to shut the pipeline product down to preempt future competition from a nascent competitor. Killer acquisitions in the tech setting raise related but different issues.

The nature of innovation, due to the regulatory process and the particular issues involved in bringing pharmaceuticals to market, is different in pharma than in digital tech. If the pipeline product is close enough to the market to be a threat, creating concerns for antitrust authorities that it will be killed, the antitrust authorities have a good idea of what the acquiring firm will do and can check competitors’ pipelines to see what the competitors have. In contrast, this approach tends to be much more elusive in digital transactions. For example, when Microsoft acquired Skype, many observers wondered how Skype would evolve and relate to Microsoft’s products.

Entrepreneurship is unique, relative to other types of business law because it involves high risk. VCs have a portfolio of investments to reduce risk because any one investment is not likely to yield big returns. This is important given the limited time-frame (typically ten years) in which the capital needs to be returned at the end of the fund. As such, VCs do not make money on over half of their average portfolio of investments. CVCs invest in a portfolio of companies for similar reasons.

The race to innovate in tech (platform, hardware, biomedical, IoT, etc.) is critical given the rapid change in and for the market. There are several internal motivations as part of this ecosystem as to acquisitions models that motivate CVCs and VCs. When established firms reach a certain size and level of complexity, they tend to be poorer at product innovation than more nimble and smaller firms. Instead, larger firms tend to be better at process innovation because of familiarity and repetition of routines and processes that reduce both search costs and information costs related to the transfer of knowledge. As larger firms have shifted risk outside the firm to start-ups to acquire (and to build out new products and services faster), larger firms need to acquire smaller firms to utilize the technology that the target firm possesses via ownership rather than via contract. They also need to make acqui-hires.

This rather unique ecosystem matters for antitrust analysis. Thus, there is a danger, with initiatives that seek to change legal thresholds or introduce new presumptions specific to tech (whatever that means) and acquisitions. For example, in the UK, there's a proposal that to block a merger involving a large platform, the CMA would only have to use the Phase 1 standard (a realistic prospect of an SLC) rather than the normal balance of probabilities used Phase 2.

Such an approach risks going too far. It diminishes the prospect of a target being acquired by a large firm as a viable exit strategy for tech startups. That, in turn, could have far-reaching negative consequences for innovation because it would make it considerably harder for start-ups to generate VC funding for risky projects. While this is a rather obvious point for those familiar with the [entrepreneurial literature](#), antitrust recently has begun to understand what is at stake.

As the [Furman report explained](#): *“Being acquired is also an important exit strategy for technology start-ups, providing significant incentive for investors to provide funding to risky projects and support market entry.”* Similarly, the [EU Special Advisors' report](#) concurred *“the chance for start-ups to be acquired by larger companies is an important element of venture capital markets: it is among the main exit routes for investors and it provides an incentive for the private financing of high-risk innovation.”* Finally, Commissioner Vestager expressed the same point in April 2020: *“We also see companies that are being created, and somewhat hope, that they will be acquired, very often for quite large sums.”* This risk assessment of chilling innovation is understood on the other side of the Atlantic Ocean as well. The February 2020 report for the President [identified](#): *“If dominant platforms were routinely deterred from acquiring start-ups, such a policy could reduce venture capital funding in this segment.”*

These concerns are why, rather than changing legal standards or introducing new presumptions, a better approach would be for agencies to *broaden* the evidence base when it comes to nascent acquisitions. Agencies could make greater use of interview powers (like the CMA in *Amazon / Deliveroo*); agencies could scrutinize transaction values (like the CMA in *Paypal / iZettle*); agencies could probe internal documents from both the parties and third parties (like the CMA in *Experian / Credit Laser Holdings (ClearScore)*), and agencies could review third-party analyst reports. Agencies could even probe VCs as to why they have invested in a particular startup and the prospects that they see for the startup absent the merger. This approach would help agencies better identify truly problematic transactions without diminishing incentives for investment and innovation. All of this should be part of the mix to better understand deal motivations and implications. However, ultimately what determines cases is understanding the economic effects and using various types of data to better predict such effects. Alas, DG Competition, responding to a populist backlash, is not willing to defend economic analysis and in speeches, by Vestager one hears more about "fairness" [without linking fairness considerations to the economic analysis](#). This needs to change. The Commission needs to be more proactive in defending economic analysis and to explain at the "retail" level to non-specialists what the competition policy system can and should deliver.

## **How do VCs look at reform trends seeking to increase antitrust activity levels against digital platforms? As the EC eyes aggressive regulation of digital platforms, is there a risk of stifling VC funding that has recorded substantial growth in Europe in past years?**

I think that VCs are looking at the unfolding situation with great concern. Overly aggressive regulation in Europe (GDPR) has had [negative consequences regarding VC investment](#). GDPR has made it harder for firms to collect, store and analyze customer data, which has created a trade-off between consumer privacy and possibly higher quality and competition in services because of the costs associated with business operations. This trade-off has impacted businesses asymmetrically, putting startups and small firms at a severe disadvantage against large firms.

Europe wants to be able to create innovative firms but overly broad regulation or competition enforcement that is not precise threatens to kill off European innovation. If Europe wants its best and brightest to move to Canada, the United States, the UK, Israel, Singapore and elsewhere to more business-friendly jurisdictions, this will have long term implications for Europe's ability to compete globally.

Precision matters. Even in the seminal Cunningham paper), the authors found that the overall impact of killer acquisitions was unclear because of how the prospect of being acquired by a larger rival incentivized innovation: *“despite the ex-post inefficiencies of killer acquisitions and their adverse effect on consumer surplus, the overall effect on social welfare is ambiguous because these acquisitions may also increase ex-ante incentives for the creation of new drug projects”* and *‘because killer acquisitions may motivate ex-ante innovation the overall effect of such acquisitions on social welfare remains unclear.’* There has been a disproportionate focus on “killer acquisitions,” which I believe to be quite rare. As most VCs will tell you, these issues do not warrant considering reversing the merger presumption. Cases like [Mallinckrodt](#) are really the exception that proves the rule.

The DMA and some speeches coming out of the Commission (including DG Comp) are also worrying VCs and CVCs. For example, entrepreneurs and VCs worry a lot about the significant discretion of the Commission to enforce the DMA. The Commission has full discretion to apply and change the criteria of gatekeepers. A gatekeeper would be subject to a number of obligations. As written, it impacts lots of companies across many different industries going through digital transformation. If they are all now gatekeepers, then it will be very difficult for entrepreneurs (and their investors) to exit such investments. The DMA is overly broad in its reach and raises due process questions. These issues need to be addressed.

We see both an increased regulatory turn of competition law and a new regulatory regime that has competition elements. To help spur investment and combat potential-anti-competitive activity, enforcers and regulators need to draw a fine line to have effective policy instruments to reward innovation and still address concerns of potential anti-competitive effects. It is not an easy task and requires great nuance. It also requires more active stakeholder involvement from the VC and CVC communities lest the rules be overly restrictive.

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