KEYNOTE INTERVIEW

Navigating regulatory change in tech investing

PE firms should keep antitrust, national security and data protection issues in mind when executing deals in the technology industry, say Baker McKenzie's Michael Fieweger and Matthew Jacobson

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Q What are the latest antitrust developments impacting firms investing in the technology industry?

Matthew Jacobson: The current administration of the US Federal Trade Commission, led by chair Lina Khan, has an aggressive approach to antitrust enforcement and a significant focus on big tech, particularly social media and advertising. At the same time, there has been continued regulatory activity around the semiconductor sector, which was also a focus of the previous administration. This scrutiny means antitrust has become a sensitive area for investors in technology, and the likelihood of regulators challenging investments is higher than it has been for some time.

Tempering that concern is the fact that this administration has also lost these challenges several times in court, which may have an impact moving forward. For now, investors need to be more attuned to antitrust issues, particularly on the sell side, and understand how a challenge could impact investment processes and targets. However, so far, antitrust scrutiny has certainly not shut down M&A in the tech industry.

Private equity firms should remember that antitrust is only one arrow in the regulatory quiver, alongside issues such as national security and data protection. The regulatory environment as a whole is certainly less laissez-faire than it was in the past.

Michael Fieweger: It will be interesting to see how the views of the FTC and those of the US Department of Justice will intersect in their regulation of private equity investment in the technology space. On several occasions, the FTC and DOJ's leadership have publicly expressed their views that private equity acquisitions have a negative effect on employment markets and do not provide investment in businesses necessary to foster competition.

At the same time, the regulators view big tech as blocking new entrants into the technology industry. As such, they have been focusing on breaking up big tech or blocking their acquisitions. It will be interesting to see how these negative views affect the ability of private equity sponsors to acquire technology businesses, in particular businesses that may be divested from big tech.

Q What kind of challenges are investors experiencing as a result of national security concerns?

MJ: National security is in many ways an even bigger issue for investors than antitrust, because it is more at the whim of government. While US-China relations have been a significant driver of national security rules for some time, there is now an assumption that issues that are not intuitively related to national security can become a national security concern. In addition, the impact of these rules is not limited to the focus countries. Some of the more targeted semiconductor rules, for example, could start to impact how companies develop new technologies, thereby affecting new innovations as well as M&A.

MF: There are certain sectors that are clearly in the government's sights. Industrial policy is essentially masquerading as national security in areas like semiconductors, microprocessors and social media. However, there are several tech segments of interest to private equity firms that are not seen as sensitive, such as software-as-a-service. Private equity investment in SaaS deals has remained robust and largely unaffected by the national security concerns.

Q What can PE firms do to navigate changes to cross-border investment restrictions, particularly around tech security?

MJ: Part of the solution is about managing your deal processes and managing your bidder group. It matters how and with whom you proceed, which means regulatory risk can be a limiting factor when you start looking at different buyers. In some ways, that offers an advantage to private equity firms because sponsors tend to present less of an antitrust risk, though they are certainly not immune.

There are also some deal terms that become significantly more important. These include terms around the regulatory process, commitments, penalties for not completing a deal, and who is going to bear that risk, for example. I know of a handful of deals where an alternative plan was needed to hive off a business in X, Y or Z country, or to not include it in the event of a regulatory intervention.

MF: Given the proliferation of foreign direct investment and merger control regulation around the globe, private equity buyers need to factor in the regulatory risk, timing delays, and added disclosure associated with the need to

Q How are data security regulations affecting private equity firms targeting tech assets?

Michael Fieweger: Data security is an issue that is going to affect everybody in the tech world, and it is a concern in every deal. It is increasingly likely that an acquisition target will be the subject of a ransomware attack at some point. We work with IT specialists to assess a target's cybersecurity capabilities and to gain an understanding of the risk faced by the company. However, as a positive for private equity, the heightened concerns around cybersecurity and data privacy have created opportunities to invest in businesses operating within the cybersecurity space.

Data security regulation is also a risk on any transaction. Mismanagement of personal information and falling afoul of data privacy laws, like the European Union's ePrivacy Directive, can result in significant potential liability and fines. This is an especially significant concern in large multi-jurisdictional carve-out acquisitions, where data storage in multiple jurisdictions and the need to transition the data adds significant complexity to data security compliance.

obtain clearances from regulators who previously would not have expected to have an impact on the transaction.

Changes in reporting requirements, such as the new HSR antitrust filing form, will create significant and burdensome disclosures regarding a private equity firm's business rationale and intentions with respect to a prospective acquisition. Sponsors should also consider the effect of regulation on buy-and-build strategies and reassess the regulatory scrutiny with respect to add-on acquisitions.

Q How are regulatory concerns affecting acquisitions, exits and deal structures?

MJ: We are going to see people paying more attention to this, particularly in carve-outs and other transactions where it might impact where parameters get drawn. However, I do not get the sense that firms are shying away from deals because of these concerns.

Private equity firms clearly need to keep doing deals, so the question is whether there are certain areas where it is not worth going through this whole process. Regulators are unlikely to shut down their plans altogether, but Chinese deals may be a quieter part of the M&A market for a while, for example. The private equity industry is still probably better situated for these deals than the goliaths of the technology market, but it is less immune to the risks than it used to be.

MF: If the target has technology that is considered sensitive from a national security standpoint, the body of potential buyers for that asset will be significantly narrowed. It doesn't mean private equity buyers are excluded, but if the target is US-based then the buyer will be disadvantaged if they are not a US-domiciled private equity firm, even if they are domiciled in a "friendly" country.

Where it is really going to hit is exits on the venture side. If regulators continue to challenge acquisitions by the big tech firms that have been natural buyers in VC exits, that creates issues for venture-backed companies. We have seen softness in the late-stage venture funding environment of late as companies have been unable to access closed IPO markets.

Regulatory scrutiny of big tech puts another block on exits, further challenging the funding environment. Interestingly, the scrutiny of big tech and private equity may dampen the innovation and competition in the technology industry that regulators seek to foster by denying start-ups of the capital they need to grow.

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> MATTHEW JACOBSON

We have not seen too much impact on deal structures. These issues can affect a buyer's ability to consolidate businesses after an acquisition because of the need to keep multiple businesses in key jurisdictions somewhat separate to avoid concentration of data or national security concerns. However, while this could reduce the buyer's ability to wring out efficiencies and synergies, the overall impact on deal structures is marginal.

Q What further developments might tech investors expect on these fronts?

MF: Competition, foreign direct investment and national security issues will continue to be a focus for governments worldwide, with an emphasis on regulating artificial intelligence and social media platforms. In terms of deals, there will be accelerated concentration in the hands of the traditional technology players because they have the scale to adapt to regulation and to shape that regulation. If you are one of the hundreds of AI start-ups out there, you are unlikely to have the capital to focus on regulatory compliance or lobbying efforts.

The Googles and Microsofts of this world have the staying power to see this through, and the large buyout firms will potentially be a part of that. Right now, the AI market is too young for those big private equity players, but we will start to see applications of AI coming into the software companies they own, creating a place for them.

Another area that is hot in technology dealmaking right now is the Internet of Things, where there is significant investment in enabling the digitalisation of historically non-digitalised businesses, services and equipment. That is subject to ongoing regulation, and we are yet to see the cybersecurity implications of the IoT revolution. Cybersecurity is a clear focus for private equity buyers in due diligence, including how they can manage that cyber risk and assess the evolution of regulatory risk in this area.

With all these developments moving forward at different paces and in different directions around the world, there is a lot for investors to manage when doing these deals. ■

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