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Interactive Entertainment and Metaverses

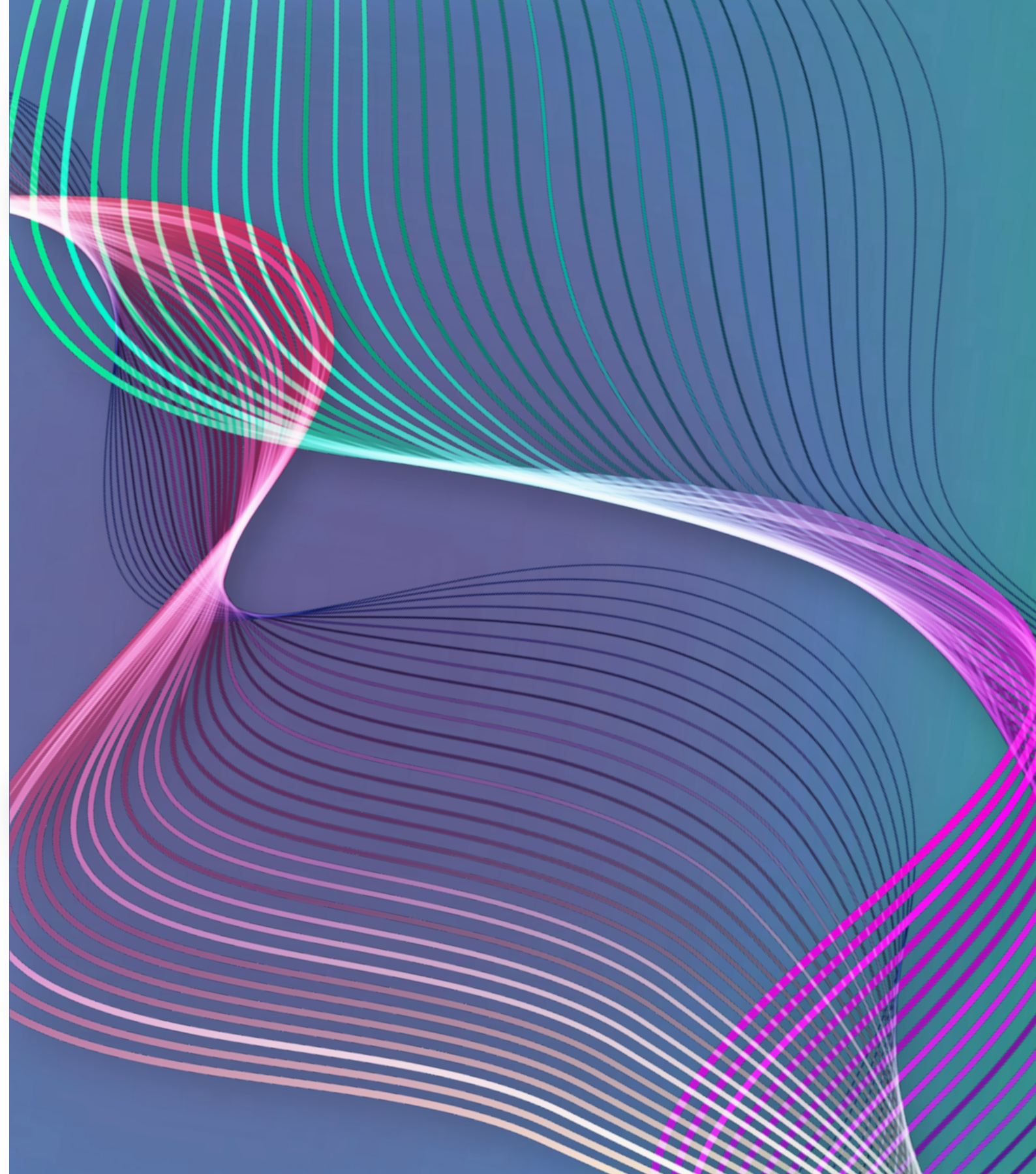
Report 3

TMT Looking
Ahead 2022



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Foreword

Technology, media, and telecommunications (TMT) companies are central to the rapidly growing Interactive Entertainment (IE) industry and to developing and building future metaverse environments. The metaverse concept has dominated headlines in 2022 and is a key theme in this third report in our series.

As the IE sector evolves from inception in entertainment to becoming an ever-present engagement environment, we can expect:



Huge investments to continue in technologies that bring metaverse environments to life, including cloud and connectivity as well as Augmented Reality (AR)/Virtual Reality (VR) technologies (the entry points to metaverses)



Record M&A deals as convergence in the video streaming and gaming sectors drives transactions — but **regulatory headwinds** are ahead



Companies revisiting their intellectual property (IP) strategies to **protect and monetize their IP** in metaverse environments to drive potentially lucrative new revenue streams



Increased regulatory focus on metaverses, including on the protection/use of data, digital payments and content moderation



Teresa Michaud
Partner, Los Angeles

This report, the third in a five-part series, explores the following key areas:

- **Section 1** reviews the important trends and the new regulatory headwinds that businesses should plan ahead for given the robust transactional landscape, where record M&A and deal values in 2022 have already outpaced that of 2021.
- **Section 2** identifies the trends that are bringing metaverses into the mainstream and the current regulatory challenges for businesses to navigate.
- **Section 3** explains how cloud computing is critical in the digital transformation journeys of IE companies looking to scale their businesses by streaming vast libraries of data-rich content, providing sophisticated cloud-based games and engaging in metaverses.
- **Section 4** shares practical tips on how to protect IP rights, including trademarks, trade secrets and valuable data, as metaverses become an increasingly indispensable distribution platforms for products and services.
- **Section 5** looks at the financial and data regulation and enforcement environment in relation to digital currencies and virtual payments that metaverse creators and service providers should grasp.

1 Outlook for M&A and Financing Transactions in the Interactive Entertainment Sector

Authored by **Lisa Fontenot**, Partner, Palo Alto and **Tino Marz**, Counsel, Munich

Record M&A and financing deal values in the IE sector of USD 85 billion in 2021¹ were quickly eclipsed by even higher deal values within the first two months of 2022, headlined by the announced acquisitions by major sector players in the technology space, including big names in software and gaming.



Consolidation — Further consolidation of the IE sector; nontraditional players will remain active

Big gaming players in the IE sector continue to seek growth and reinforced protection of market share. These trends will drive further consolidation of the IE sector, with small and midsize targets in the future finding themselves under the roof of big entertainment conglomerates.

Expect to See:

- Continued, strong private equity activity, in particular regarding entertainment companies developing and using technologies such as AI, blockchain and gamification
- IE-focused Special Purpose Acquisition Companies (SPACs), raising expectations of additional activity to bring more private players to the public markets



Convergence — Business transformation, impact and talent will drive acquisitions

Gaming companies are embracing new business models expanding into different areas of “technotainment” or leveraging blockchain and digital assets with the explosion of token activities to expand user acquisition and engagement and drive monetization opportunities.

Recent examples across the IE sector include:

- Gaming companies expanding further into the music sector or acquiring new game genres or comic books
- Acquisition of a recent major Hollywood studio by a technology company
- PC and console companies buying mobile gaming companies as well as new moves in streaming and cloud gaming

The desire to leverage these new digital asset strategies further is also driving transactional activity.

Expect to See:

- More acquisitions with the purpose of transforming existing acquirer business models or being targeted to have a strong impact on business model change
- Multifaceted convergence driving equity financings in 2022, where companies will aim to acquire targets that provide knowledge and talent for business expansion



Headwinds — New scrutiny from regulatory authorities creates challenges for transaction processes

Dealmakers in the IE sector will face increasing scrutiny from regulators globally due to the convergence of tech subsectors, and the importance of AR/VR vis-à-vis metaverses.

Rising focus on data collected by transaction parties may cause merger control authorities to conduct more detailed reviews of transactions in this sector.²

Expect to See:

- The Committee on Foreign Investment in the United States (CFIUS) examine transactions involving “critical technologies” such as AI and consider the data collected from users by the transaction parties
- Foreign investment authorities in Europe further assessing the extent to which entertainment and games can be characterized as media or opinion-building platforms, thus requiring the approval of authorities
- Foreign investment restriction changes in Mainland China applicable to investments in the entertainment and gaming sector (for internet companies holding the data of more than 1 million users) and use of variable interest entity (VIE) structures

¹ DrakeStar Report citing CapIQ, Pitchbook and DSP Research

² Margrethe Vestager, Executive Vice President, European Commission referenced this vis-à-vis Europe Fit for the Digital Age.

2 Metaverse Concepts Go Mainstream

Authored by **Ashlin Perumall**, Partner, Johannesburg and **Francis Donnat**, Partner, Paris

Metaverses have been dominating headlines and garnering incredible capital investment. From social media companies to fashion labels to financial consultants and banks, few industries are left unaffected by the hype cycle.

However, despite the expanding meaning of the term, the origins of trends around metaverses lie in the world of IE and interactive media. To date, innovation in content, commerce and the architecture of the internet itself has reached critical mass, and ideas of AR and VR are being brought to a mainstream audience beyond the gaming industry.

Regulatory challenges ahead

A rethink in how mainstream content is consumed is underway to reflect an increasing appetite for more immersive experiences. Such change comes with new legal challenges, including a need for new frameworks for brand and IP protection strategies, new techniques for age-related content control and better policies for data protection and privacy.



While existing laws are already being stretched to govern such issues in metaverses through litigation, the limits of their applications have quickly become apparent in this new environment.



As policymakers and regulators begin to develop rules and governance strategies for participants in this industry, the scope for compliance risk is only set to increase.



Companies investing in this space will no doubt require acute technical understanding from their legal advisors as a means to control risk in these new ventures.

Why now?

Three major causes precipitate this watershed moment:

- the state of key technologies
- a tectonic shift in the commercial and value ecosystem
- a cultural acceleration in adoption



The resources available to IE firms today far surpass what was available just two decades ago. For example, the 5G bandwidth explosion has vastly increased what can be achieved remotely.



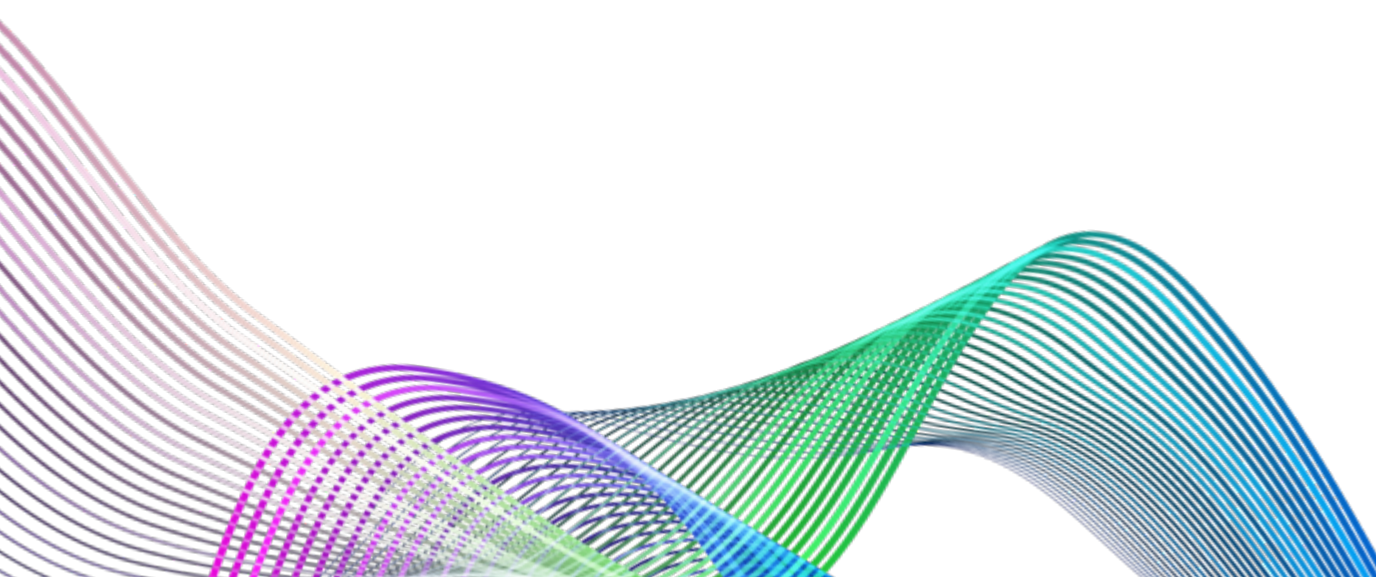
Leaps in computing and cloud-based processing resources have opened new possibilities for the rendering of virtual environments and the serving of these to mobile devices and VR headsets.



Digital disruption of financial intermediaries and value systems has been brought about by the increasing interfaces between financial services and online environments, as well as new systems for commercial trust created by blockchain assets such as cryptocurrencies, stablecoins and non-fungible tokens (NFTs).



Ultimately, a cultural shift is taking place as the demographic of entertainment consumers changes. As the “digital native generation” reaches adulthood, gaming culture has begun moving to the center of mainstream entertainment — the growth of eSports viewership for instance. The pandemic has also undoubtedly accelerated this transformation by increasing the appetite for virtual forms of entertainment whilst also bringing new entrants.



3 How the Cloud Is Driving Interactive Entertainment

Authored by **Dominic Edmondson**, Senior Associate, Hong Kong and **Carlos Vela-Treviño**, Partner, Mexico City

IE companies are accelerating their adoption of cloud services, and the use of data, as they position themselves to remain competitive. The ability to offer vast libraries of compelling content on demand or provide optimal gaming experiences will allow businesses to thrive in a market that continues to quickly consolidate. Likewise, data remains a crucial asset, with its collection, storage, location, exploitation, analysis and protection all critical to success.

Cloud Is Critical

IE platforms and gaming companies have been quick to learn the benefits of scalability, agility, operational efficiency and cost-effectiveness of cloud computing services. This comes as a result of market competition and consumer expectations, as well as the vulnerabilities and expense of maintaining on-premises servers.

The cloud is a critical component of digital transformation. Recent acquisitions show the importance for IE companies to bring together strong content titles with a robust cloud infrastructure and streaming offerings in order to drive deal value. As consumers push for more multi-platform game availability, one-to-many gaming updates and patches, as well as the promise of a gaming experience agnostic to physical hardware, companies will have to diversify their offerings and focus on expansion.

A key theme in 2021 was a focus on realizing CAPEX to OPEX by moving to the cloud. The advent of a plurality of interactive metaverse environments (whether centralized or decentralized) will only accelerate this trend. Likewise, the ability of IE companies to analyze vast quantities of data will also enable them to ramp up their AI efforts, which will have a positive impact on communications, customer engagement and revenue streams. The effective use of AI in turn increases the ability of IE companies to respond more quickly to customer needs and expectations.

Data & Content Regulation

Increased availability of data and improved means for data processing present new opportunities, from operational improvements to monetization. However, these also bring new internal and external risks, including:

Privacy and Cybersecurity

Respondents from the 2021/2022 **Digital Transformation & Cloud Survey** reveal their key concerns around data privacy and cybersecurity, including:

- How data is secured and stored and the risks of exposure to data breaches
- Managing the increasing volume of cross-border data regulation
- Keeping pace with digital transformation progress and international growth plans amid complex and potentially prohibitive local legislation
- A limited ability to reduce regulatory risk by shifting risk to cloud providers via contract terms

Ultimately, reducing cyber risks through proper data management will remain an important pillar of any cyber security program.

Content Regulation

- Legislatures are increasingly expanding their views on their ability to regulate content.
- The same content may cause different legal issues in different jurisdictions, depending on local regulators and the courts' views on freedom of speech, child protection, political rights, gambling and other issues.
- With content being produced on a one-to-many model, IE companies should be prepared to face litigation, political pressure, negative publicity and even blocking by local governments.

4 Protecting Your Interactive Entertainment and Metaverse Assets

Authored by *José María Méndez*, Partner, Madrid and *Marcela Trigo*, Partner, Trench Rossi Watanabe*, Rio de Janeiro

As metaverses become indispensable platforms for the distribution of products and services, companies have an opportunity to position themselves as innovators but must also develop strategies to meet the challenges posed to the protection of their IE assets and the enforcement of related IP rights.



Protection and enforcement of IP rights

Before commencing operations in metaverses, businesses should put safeguards in place to protect their assets in the physical world. This involves a prior review and updating the process of the classes for which their trademarks are registered.

Businesses should also analyze whether the activities they intend to develop in a metaverse may give rise to assets eligible for protection (e.g. user interfaces, avatars, etc.) and, if so, (i) which type of IP safeguard best suits these assets and provides the highest level of protection, as well as (ii) how enforcement measures will take place at this challenging interactive space.



Contracting for metaverses

Due to the nature of collaboration with suppliers and intermediaries in developing software and products, businesses should build a contractual structure capable of (i) securing ownership of their proprietary assets and (ii) enabling user interoperability and the flow of the assets across different metaverse environments.

Solutions should not only be developed to encourage the open use of assets, but also safeguard the interests of rights-holders and permit the identification of infringing users.

Businesses should consider how such uses might differ from those occurring in the physical world and what amendments are needed to ensure consistency between their licensing schemes and their IP portfolios.



Protection of valuable data

Activity in a metaverse environment generates a vast volume of data that is of great value to businesses. Access to this data provides a significant competitive advantage, especially in the early stages of migration of transactions into metaverses.

Businesses should balance protection and proprietary access to this data with the interoperability and open traffic needs across different future metaverse environments.

It is essential to explore new protection solutions tailored to the specific security challenges posed by the metaverse environment.



Developments in metaverses

Metaverse development requires various assets which may be eligible for protection under different IP regimes. Businesses must carefully select the elements involved in their development activities, so as not to jeopardize the future protection of developed assets, especially when it comes to the use of open source software.

Companies should ensure that all providers, users and employees contributing creatively to the development of the assets are engaged under contracts which guarantee the ability to exploit rights in said assets and establish protections against any eventual claims.

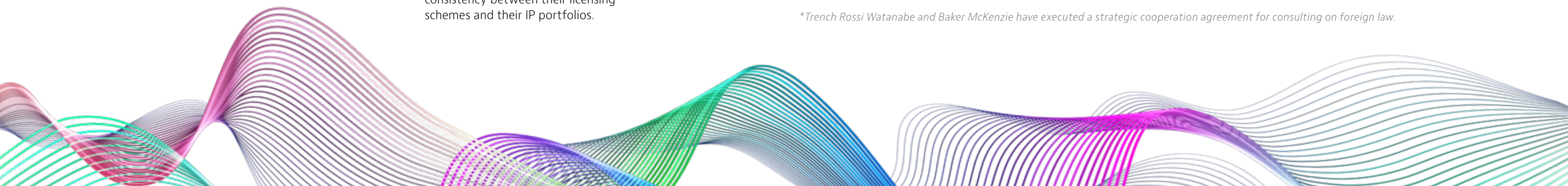


Protection of trade secrets

Trade secrets might become vulnerable in a metaverse, taking into account that they are already poorly protected in the real world.

For the purposes of protecting trade secrets, companies seeking to enter a metaverse should ensure that they: (i) identify assets that may be susceptible to protection through trade secrets; (ii) comply with the required measures to protect such assets as trade secrets; (iii) have a protocol for the protection of trade secrets or a policy for action in case of secrecy breach; and (iv) assess the impact of operating in the metaverse on the protection of trade secrets.

**Trench Rossi Watanabe and Baker McKenzie have executed a strategic cooperation agreement for consulting on foreign law.*



5 Virtual Payments in Metaverses

Authored by **Stephanie Magnus**, Principal, Singapore and **Jonathan Tam**, Partner, San Francisco

Many creators of metaverse and virtual worlds seek to create environments in which parties can buy and sell offerings and transact in payments of both fiat and virtual currencies. Creators and service providers must assess whether such transactions will attract regulatory review and licensing.

Financial services regulation — complex patchwork of laws

Although the metaverse concepts seek to cross national boundaries, the laws and regulations relating to payments and the buying and selling of virtual currencies vary from jurisdiction to jurisdiction — creators need to be aware of and comply with these laws.

In the United States (US):

Payment processors participating in the online space must be aware of state and federal regulations potentially applicable to their activities, as well as the increased scrutiny of payment processors from agencies like the Consumer Financial Protection Bureau.

Payment processors must carefully assess whether they are engaged in “money transmission” to determine whether they are subject to federal registration and anti-money laundering program requirements that are implemented and enforced by the US Department of the Treasury’s Financial Crimes Enforcement Network (FinCEN).

In Singapore:

The Payment Services Act governs both payments in fiat but also dealing in “digital payment tokens,” which includes virtual currencies and other tokens intended for the use of payments of goods and services.

Parties who deal in both fiat and “digital payment tokens” will need to be appropriately licensed. While the payment services laws are generally territorial, there are also typically non-solicitation provisions to ensure that individuals in each country are protected. Moreover, businesses should be aware that know-your-customer and anti-money laundering issues and concerns are driving much of the regulation in this space.

Data and industry standards

Payment processors must also handle data associated with payments in compliance with applicable data privacy and protection laws and industry standards.

Virtually every state in the US requires a company to notify affected individuals if it suffered a qualifying data breach resulting in the unauthorized acquisition of payment card numbers or account numbers along with a name and access code. The Payment Card Industry Data Security Standards also contractually apply to many companies in the payment card ecosystem and establish specific data security and breach notification obligations.

The federal US Gramm-Leach Bliley Act (GLBA) imposes detailed privacy and security obligations on “financial institutions.” The Federal Trade Commission, which enforces the GLBA, has taken steps in recent years to significantly engage in activities that are incidental to financial activities and certain types of service providers that financial institutions rely on, which may include payment processors.

State-specific privacy laws also create privacy and security obligations that generally apply to any company that does a significant amount of business with consumers in the state, and these requirements can also apply to payment processing activities.

Outside the US, data privacy regulators are also active in their review of enforcement in an increasingly connected world where data is transmitted on a cross-border basis.

6 Conclusion

As your business explores metaverse possibilities, it is essential to consider key risk areas and what you can do to mitigate risks, protect IP assets and harness the full growth potential of this dynamic space.

Below are nine key takeaways and practical tips:

Opportunities Abound

Metaverses will provide businesses with attractive new opportunities to position their brands, products and services in an innovative and stimulating way, and many are already participating.

M&A Scrutiny Expected to Intensify

Regulatory bodies, particularly antitrust and foreign investment agencies, are expected to further scrutinize mergers and acquisitions as well as significant investments in the IE sector.

Dealmakers will benefit from early, proactive assessments of potential challenges — which will allow parties to more successfully complete transactions within their desired timeframes.

CAPEX to OPEX Shift

The trend of IE sector players moving CAPEX to OPEX by migrating to the cloud with the resulting scalability, increased security, agility and costs savings is likely to further accelerate with the advent of a plurality of future metaverse environments.

Emerging Tech Is Essential

Understanding metaverses will require engaging with some of the emerging elements, such as access technologies (including AR and VR), the evolution of Web3 internet architecture and its governance, as well as commerce asset-ownership models borrowed from the blockchain ecosystem.

New Legal Frameworks Will Emerge

Current iterations of metaverses raise questions on the evolution of online identity, content convergence, ownership of digital assets, decentralization, law and jurisdiction and legal accountability. New frameworks will be needed to assess risks and develop mitigation strategies across legal concerns from intellectual property to data protection to content regulation.

Digital Commerce Plays a Crucial Role

Metaverse engagement will rely on digital commerce. This brings into play complex jurisdiction-specific financial regulations, which are increasing in scope and reaching further into the digital payments ecosystem. Consider if a license is required for the financial activities being performed and whether a digital currency is regulated.

Consolidation of the IE Sector

Big players, private equity funds and SPACs will further drive the consolidation of the IE sector.

Continued strong private equity activity in AI, blockchain and gamification technologies is expected as they are further deployed in the IE sector.

IP Protection Is Paramount

Rights-holders need to put in place a clear strategy and framework for both the protection and enforcement of their IP rights across several future metaverse environments.

Consider how your brand will deal with virtual counterfeited goods and how IP dispute resolutions and takedown on metaverse platforms will best work.

Eye on Multijurisdictional Privacy Laws

Financial players must also be fully compliant with privacy laws that vary from jurisdiction to jurisdiction. Privacy regulators are increasingly active in enforcement in this space and where data is being transmitted cross-border.

7 Key Contacts



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