COMPETITION COMMISSION

Sector Treasury Services and Butlers

A report on the completed acquisition by Sector Treasury Services Limited of ICAP PLC's treasury management advisory services business (Butlers)

31 August 2011

Website: www.competition-commission.org.uk

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The Competition Commission has excluded from this published version of the report information which the inquiry group considers should be excluded having regard to the three considerations set out in section 244 of the Enterprise Act 2002 (specified information: considerations relevant to disclosure). The omissions are indicated by [✂]. Some numbers have been replaced by a range. These are shown in square brackets. Non-sensitive wording is also indicated in square brackets.

Completed acquisition by Sector Treasury Services Limited of ICAP PLC's treasury management advisory services business (Butlers)

Contents

Page

Summary

1. On 31 March 2011, the Office of Fair Trading (OFT) referred to the Competition Commission (CC) for investigation and report under the Enterprise Act 2002 (the Act) the completed acquisition by Sector Treasury Services Limited (STS) of Butlers, a trading division of ICAP plc (ICAP) which provided treasury management advisory (TMA) services. We are required to report by 14 September 2011.

2. STS is based in London and is a wholly-owned subsidiary of Capita Business Services Limited, itself a subsidiary of the Capita Group plc (Capita). Before the merger, Butlers was based in London and was a trading division of ICAP Securities Limited (ISL), a wholly-owned subsidiary of ICAP.

3. Before the merger, both STS and Butlers provided TMA services to local authorities in the UK (among other clients). Some of these services were provided under retainer contracts (usually of several years' duration, with fixed fees charged annually) and some of these services were provided under 'one-off' contracts, for specific pieces of advice provided over a short space of time. The only other providers of TMA services to UK local authorities under retainer contracts are Arlingclose Limited (Arlingclose) and Sterling International Brokers Limited (Sterling).

4. As a result of STS's acquisition of Butlers, STS's share of supply of TMA services provided to UK local authorities under retainer contracts exceeded 25 per cent. We were therefore satisfied that we had jurisdiction in relation to this merger.

5. Treasury management is the process by which public and private sector bodies manage their cash flows and associated financial risks. This includes deciding when, for how long and with whom to invest surplus funds and/or from whom to borrow additional funds and on what terms. External advisers may be engaged by these bodies to assist them with their treasury management activities by providing TMA services. In the case of local authorities, TMA services can, for example, include providing information on changes to public credit ratings and providing information on the pros and cons of various investment and borrowing options.

6. We assessed the effect of the merger in the market for the supply of TMA services to UK local authorities under retainer contracts, which we found to be the relevant market for the purposes of our inquiry.

7. In order to establish a baseline for assessing the effect of the merger on competition, we needed to determine what was likely to have happened to Butlers had it not been sold to STS. This is known as 'the counterfactual'. We examined the three other options open to ICAP in relation to Butlers, had it not sold Butlers to STS:

(a) exit by sale to an alternative purchaser;

(b) exit by closure (whether immediate or gradual); or

(c) retention of the Butlers business within ICAP.

8. Whilst Arlingclose told us that it would have been interested in acquiring a part of, or possibly all of, Butlers' contracts and staff, and we considered that Arlingclose would have been a viable purchaser, it was not necessary for us to carry out a detailed assessment to establish whether a sale to Arlingclose was the most likely alternative to the merger. This was because we believed that a sale of Butlers to Arlingclose would have been likely to raise sufficient concerns about competition that it would have been referred by the OFT to the CC for investigation. We therefore did not

pursue further a counterfactual in which Arlingclose acquired Butlers. We did not identify any other viable alternative purchasers. As a consequence, our analysis focused on the question of whether ICAP would have retained or closed Butlers in the absence of the merger.

9. Butlers was not failing financially. However, the evidence showed that ICAP faced wide-ranging regulatory pressures across its businesses that placed considerable pressure on ICAP senior management and required it to prioritize its efforts on ICAP's core businesses. In addition, Butlers faced particular strategic issues. These included its small scale within ICAP as a whole, its declining profitability following the Icelandic banking crisis (requiring scarce management time and resources to improve) and management succession concerns. We found that these particular and exceptional circumstances made it commercially rational for ICAP to close Butlers rather than retain it, in the absence of a sale to STS.

10. We concluded that the counterfactual was that ICAP would have immediately made a decision to close Butlers, and would then have gradually wound down its contracts with a view to full exit in the foreseeable future. We assumed that Butlers' contracts would have gradually been retendered, and would have been distributed around the remaining market participants according to the historic pattern of bidding success in the market.

11. The evidence we gathered on closeness of competition suggested that Arlingclose, STS and Butlers were all very close competitors before the merger. However, both following the merger and in the counterfactual, the number of market participants would have declined from the four that existed pre-merger (STS, Butlers, Arlingclose and Sterling) to three (STS, Arlingclose and Sterling). The merger did not therefore cause a reduction in the number of market participants compared to the counterfactual.

12. STS's market share following the merger is somewhat higher than it would have been had Butlers exited gradually as envisaged in the counterfactual. However, there was evidence that, once an operator was present in the market, it could grow irrespective of its existing market share. Arlingclose, STS and Butlers had been able to compete strongly in the past despite differences in market shares. As a result, we concluded that future competition was unlikely to be significantly affected in comparison with the counterfactual merely as a result of differences in the size of competitors' market shares.

13. We found that there was one potentially significant difference between the merger and the counterfactual, arising from the differences in timing of the retendering of Butlers' existing contracts. Following the merger, all Butlers' contracts were immediately transferred to STS, giving STS an opportunity prior to the retendering of those contracts to build up any incumbency advantage that might exist. In the counterfactual, Butlers' contracts would gradually be retendered over a period of time, without the opportunity for any of the remaining market participants to build up any such incumbency advantage. This could potentially allow STS to make less attractive bids following the merger than in the counterfactual when Butlers' contracts were retendered. This would be to the detriment of the three-quarters of Butlers' local authority clients that STS would be likely to retain following retendering.

14. The evidence indicated that, once a local authority had established a good relationship with a TMA service provider, it might look more favourably on that provider in any retendering process. For about one-quarter of contracts, the incumbent provider might also benefit from a rollover of its contract at the end of its original contract term. However, there were indications that STS's incumbency advantage in relation to ex-

Butlers' contracts might be lower than suggested by our analysis of historic data. These included the facts that Butlers' clients did not choose to become STS's clients, and that STS inherited these contracts part way through their term (and would therefore not have the entire contract term in which to build up its relationship with these clients).

15. We concluded that the merger was likely to cause a small reduction in competition compared with the counterfactual in relation to those Butlers' contracts that would be renewed through retendering. Given the small overall size of the relevant market, we believed that the impact of this small reduction in competition was likely to be minor.

16. We found that the merger may not be expected to result in a substantial lessening of competition (SLC) in the market for the supply of TMA services on a retainer basis to UK local authorities.

Findings

1. The reference

1.1 On 31 March 2011, the OFT, in exercise of its duty under section 22(1) of the Act, referred to the CC for investigation and report the completed acquisition by STS of Butlers, a trading division of ICAP which provided TMA services. The reference requires us to determine:[1]

(a) whether a relevant merger situation has been created; and

(b) if so, whether the creation of that situation has resulted or may be expected to result in an SLC within any market or markets in the UK for goods or services.

1.2 We are required to report by 14 September 2011. Our terms of reference are in Appendix A, together with an explanation of how we have conducted our inquiry.

1.3 This document (together with its appendices) constitutes our report. Non-commercially sensitive versions of the main party and third party written submissions are on our website, along with other documents relevant to this inquiry. We cross-refer to them where appropriate.

2. The services, the customers and the companies

The services and the regulatory framework

2.1 Before the merger, both STS and Butlers provided TMA services to local authorities[2] in the UK (among other clients). Some of these services were provided under retainer contracts (usually of several years' duration, with fixed fees charged annually) and some of these services were provided under 'one-off' contracts, for specific pieces of advice provided over a short space of time. The only other providers of TMA services to UK local authorities under retainer contracts are Arlingclose and Sterling.

2.2 Treasury management is the process by which public and private sector bodies manage their cash flows and associated financial risks. It includes deciding when, for how long and with whom to invest surplus funds and/or from whom to borrow additional funds and on what terms.[3] Local authorities (and other prescribed bodies) are able to borrow money from the Public Works Loan Board (PWLB)[4] or from other public sector or commercial organizations.

2.3 External advisers may be engaged by private or public sector bodies to assist them with their treasury management activities by providing TMA services. In the case of local authorities, TMA services can typically cover all or some of:

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[1] Section 35 of the Act.
[2] Metropolitan councils, district councils, London borough councils, borough councils, county councils and unitary councils For the purposes of this inquiry, this term does not extend to housing associations, police authorities, fire authorities or other public sector organizations.
[3] The Chartered Institute of Public Finance and Accountancy (CIPFA), the professional body for practitioners of public finance, describes treasury management as '… the management of cash flows, banking, money-market and capital-market transactions; the effective control of the risks associated with those activities; and the pursuit of optimum performance consistent with those risks. This definition is intended to embrace an organisation's use of capital and project financings, borrowing, investment, and hedging instruments and techniques'.
[4] PWLB is a statutory body operating within the United Kingdom Debt Management Office, an Executive Agency of HM Treasury. PWLB's function is to lend money from the National Loans Fund to local authorities and other prescribed bodies, and to collect the repayments.

(a) helping local authorities meet their obligations under the relevant legislation and codes of practice (see paragraphs 2.7 and 2.8);

(b) keeping local authorities up to date with changes to public credit ratings;

(c) explaining how the Bank of England, PWLB and money market work;

(d) providing information on the pros and cons of various investment and borrowing options;

(e) assisting with the use of financial risk management techniques;

(f) helping local authorities account for their investment and borrowing decisions; and

(g) training local authority officers and members (ie elected officials) on treasury management issues.

2.4 The Financial Services Authority (FSA) is the independent regulator of the financial services industry in the UK. It is not necessary to be authorized by the FSA to provide TMA services.

2.5 However, a TMA service provider will require authorization by the FSA if it wishes to provide any service which is a regulated activity as defined by the Financial Services and Markets Act 2000 (FSMA).[5] Regulated activity includes 'advice given to a person in his capacity as an investor or potential investor (or in his capacity as an agent for such a person) on the merits of his buying, selling, subscribing for or underwriting a security or relevant investment or exercising certain rights conferred by such investment'[6] (termed 'regulated investment advice' in this report). The provision of broad strategic advice or generic advice on investments (eg a recommendation to invest in a particular type of financial instrument, without recommending a specific transaction) is not regulated investment advice. In addition, advice on making cash deposits is not classified as regulated investment advice, as cash deposits are not listed in the RAO. The advice provided by STS (but not Butlers) included regulated investment advice.

Customers

2.6 According to the 2011 edition of the Municipal Year Book, there are 433 local authorities in the UK, comprising 135 Unitary Authorities, 36 Metropolitan Districts, 33 London Boroughs, 27 Shire Counties and 202 Shire Districts.

2.7 In relation to their treasury management activities, local authorities are required by legislation[7] to have regard to two codes of practice published by CIPFA:

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[5] The list of 'regulated' activities is set out in the FSMA (Regulated Activities) Order 2001 (the RAO).

[6] FSMA RAO, regulation 53.

[7] The current legal framework in Great Britain governing treasury management within local authorities is based on the Local Government Act 2003 (the 2003 Act) in England and Wales and the Local Government in Scotland Act (the 2003 Scotland Act) in Scotland. The controls and powers in the 2003 Act and 2003 Scotland Act were developed further by regulations under the Local Authorities (Capital Finance and Accounting) Regulations 2003 for local authorities in England and Wales, and under SSI No. 229 for local authorities in Scotland. The 2003 Act and the 2003 Scotland Act brought about an end to the 'approved investments' regulation ('approved investments' under Part 4 titled Local Authorities (Capital Finance) (Approved Investments) Regulations 1990 of the Local Government and Housing Act 1989) whereby local authorities were required to invest only in counterparties on a Government-approved list. The collapse of one such counterparty in 1991, ie the Bank of Credit and Commerce International, resulted in a series of events which led to a change in the law with the enactment of the 2003 Act and the 2003 Scotland Act, and the replacement of the 'approved investments' regulation with a more flexible system whereby local authorities were given powers to invest for: *(a)* any purpose relevant to their statutory duties; or *(b)* investments made in the course of their treasury management.

(a) the CIPFA Code of Practice on ‘Treasury Management in the Public Services’, also known as the TM Code, which sets out guidance in relation to the requirements of statutes and regulations, and in relation to common practices and current issues specific to local authority treasury management; and

(b) the CIPFA ‘Prudential Code for Capital Finance in Local Authorities’ (the Prudential Code), under which local authorities are required to self-regulate the ‘affordability, prudence and sustainability’ of their capital expenditure and borrowing plans. The Prudential Code also requires local authorities to ensure that their treasury management practices are in accordance with good practice.

2.8 In England and Wales local authorities are required to have regard to statutory and informal guidance[8] from the Department for Communities and Local Government (DCLG) and the National Assembly for Wales respectively when making decisions on the types of investments to make or the type of instrument to use.[9]

STS

2.9 STS is based in London and is a wholly-owned subsidiary of Capita Business Services Limited, a subsidiary in the Investor and Banking Services division of Capita. Capita is a UK-listed company which focuses on providing business process outsourcing services to the UK public sector. STS operates out of offices in London, Basingstoke, Bristol and Edinburgh.

2.10 For its financial year ended 31 December 2010, Capita generated consolidated revenues of £2.8 billion and Capita’s Insurance and Investor Services division[10] generated total revenues of £366.1 million, of which STS accounted for [0–10] per cent with revenues of £[✂] million (including part-year post-acquisition revenues from Butlers). STS made a profit before tax on these revenues of £[✂] million. Further details of STS’s historical financial performance, and the effect of the acquisition of Butlers on its financial figures, are set out in Appendix B.

2.11 STS describes itself as a ‘leading and independent provider of capital financing, treasury advisory and strategic advisory consulting services to the public sector’. In FY2010, STS generated [75–100] per cent of its revenues from the UK public sector, with clients from local government ([70–80] per cent of STS’s FY2010 revenues), housing ([10–20] per cent) and health ([0–5] per cent). [0–5] per cent of STS’s revenues came from corporate clients and the remaining [0–5] per cent from inter-company Capita revenues (see Appendix B for further information).

2.12 STS provides services through two business divisions (Advisory and Consultancy). Its Advisory division provides TMA services to local authorities and housing associations and Asset Finance Advisory services.[11] STS’s TMA services to local authorities generate revenues through:

(a) Retainer contracts, under which fees are typically payable by clients as an annual fee over the duration of the contract (ranging from on average one to three

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[8] Statutory guidance covering England and Wales, introducing the concepts of ‘specified’ (lower risk) and ‘non-specified’ (higher risk) investments, and the Annual Investment Strategy (subject to approval by the full council, which sets out its policy for managing investments and giving priority to security and liquidity considerations in relation to its investments).
[9] The guidance requires them to follow certain core principles when making investments: *(a)* to make deposits secure based on risk assessment and management; *(b)* ensure sufficient liquidity for their daily demands; and *(c)* produce the highest available yield, once the first two considerations have been met, ie the investment principles of security, liquidity and yield. A separate statutory guidance was not issued for the 2003 Scotland Act.
[10] Capita’s Insurance and Investor Services division became Capita’s Investor and Banking Services division in 2011.
[11] STS told us [✂].

years).[12] STS's revenue from local authority TMA retainer contracts in FY2010 (excluding those related to asset finance) was £[✂] million.

(b) One-off contracts for project-management type services. STS told us that its retainer contracts generally included a separate facility to provide additional services (eg specific advice or project management) on a one-off basis based [✂].[13] STS's revenue from local authority TMA one-off contracts (excluding those related to asset finance) in FY2010 was £[✂].

(c) Transactional income (amounting to £[✂] in FY2010, excluding transactional income relating to asset finance), ie non-contractual income arising from:

(i) a share of the brokerage fees earned by the money broker Tullet Prebon, paid to STS if an STS client elects to transact through Tullet Prebon in relation to the arrangement of Lender's Option Borrower's Option (LOBO) loans;[14]

(ii) introductory commission arrangements with certain banks in relation to client deposits. STS receives a fee from the bank if an STS client chooses to deposit its funds into a 'call and notice'[15] account with one of these banks; and

(iii) a share of revenues from SunGard whenever STS's TMA clients elect to use SunGard's money market portal.

2.13 In its 2011 business plan, STS stated that it considered 'retainer fee services' to be [✂]. The vast majority of STS's transactional income arises from its work with local authorities. Further details of the nature of STS's different revenue streams, the significance of transactional income for STS's profitability and STS's business strategy are set out in Appendix B.

2.14 STS currently employs [✂] staff[16] in its Advisory division, including the employees transferred to STS from Butlers, and [✂] in its Consultancy division. Capita provides STS with the following central functions: Compliance, Human Resources, Legal and Finance. Further details of STS's organizational structure are set out in Appendix B.

2.15 Before the merger, STS had [✂] local authority clients and [✂] housing association clients in addition to other public sector clients. Of its [✂] local authority clients, [✂] were TMA retainer clients. As a result of the merger, STS's local authority TMA retainer clients increased by [✂].[17]

2.16 STS's TMA services comprise:

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[12] Based on STS data over the last five years, annual retainer revenue ranged from £[✂] to £[✂] per contract, with an average annual value of £[✂] per contract.
[13] Based on STS data over the last five years, the average value of one-off contracts was £[✂].
[14] A LOBO is a loan in relation to which the lending bank has the option to change the interest rate. In return, the lender offers the borrower *(a)* access to financing of a greater maturity (and/or at a lower interest rate) than the borrower could normally obtain; and *(b)* the option to repay the loan without penalty in the event that the lender opts to change the interest rate. STS told us that banks were currently not offering LOBOs to local authorities, and that it was not in a position to speculate as to whether the LOBO market would remain closed for the remainder of FY2011, or, if it were to reopen, when this might take place. However, STS told us that it was aware of one pension fund advancing a small number of loans to local authorities recently, although it did not believe that this provided suitable liquidity to facilitate the reopening of a market in LOBOs.
[15] Unlike time deposits with fixed maturity dates, a 'call and notice' account is a deposit facility where the deposit can be repaid at call (same day) or on a set date after the notice period has been met.
[16] Excluding the additional staff from its recent acquisition of Tribal Consulting Limited's housing team.
[17] As set out in paragraph 3.2, around [✂] retainer contracts were transferred to STS when STS acquired Butlers, of which around [✂] were local authorities. STS already had relationships with some of Butlers' local authority clients.

(a) advice on treasury management practices and procedures;

(b) annual balance sheet analysis;

(c) confirmation of client's capital financing requirement calculations;

(d) provision of interest rate forecasts, daily economic and investment bulletins;

(e) ongoing debt management advice, including advice on PWLB and market loan borrowing (which may include regulated advice), debt restructuring and repayment advice;

(f) investment advisory services (including credit risk reporting), providing both regulated and unregulated investment advice to clients (see paragraph 2.5).[18] Unregulated advice includes advice on counterparties and credit rating updates;

(g) treasury management training, workshops and seminars;

(h) local government capital and technical advice (including regulated advice);

(i) providing templates for key treasury management reports;

(j) attending meetings to review clients' financial strategies; and

(k) giving clients access to data and technical advice on STS's website, and its monthly publications.

2.17 STS is authorized and regulated by the FSA for the provision of certain investment advisory services as part of its TMA services, as well as for the provision of regulated investment advice on certain borrowing instruments.

ICAP and Butlers

2.18 Prior to the merger, Butlers was based in London and was a trading division of ISL, a wholly-owned subsidiary of ICAP. Butlers traded under the 'Butlers' and 'Butlers Asset Finance' names.

2.19 ICAP is a UK-listed inter-dealer broker and provider of post-trade risk and information services. ICAP matches buyers and sellers in the wholesale markets in interest rates, credit, commodities, foreign exchange, emerging markets, equities and equity derivatives through voice and electronic networks.

2.20 Butlers accounted for just less than [0–10] per cent of ISL's revenues, and [0–5] per cent of ICAP's revenues, for its financial year ended 31 March 2010, with total Butlers' revenues of around £[✄] million compared with ISL's total revenues of £177.7 million and ICAP's revenues of £1,605 million. Butlers made an operating profit (after ICAP central cost allocations) on these revenues of £[✄] million, representing [0–5] per cent of ISL's operating profit of £123 million, and [0–5] per cent of ICAP's operating profit of £354 million. Further details of Butlers' historical financial performance are set out in Appendix B.

2.21 At the time of the merger in October 2010, Butlers had [✄] clients, of which [✄] were local authorities. Butlers offered retainer TMA services to [✄] local authorities.

[18] STS told us that it provided very little regulated investment advice (estimated to be [0–15] per cent of STS's business).

Butlers' non-local authority clients included police authorities, health trusts, housing associations and universities.

2.22 Butlers' revenues fell into three categories:

(a) retainer contract fees, the principal source of Butlers' revenues, with fees charged on an annual basis and agreed at the start of a contract period;[19]

(b) one-off project work, in relation to which the terms of the project would be discussed with the client and a fee agreed in accordance with the amount of work that the project would require;[20] and

(c) transactional income, another main source of Butlers' revenues, arising from Butlers referring its clients to [ICAP] and receiving a share of the brokerage fees from any resulting transactions involving certain money market instruments (eg LOBOs).

2.23 The impact of Butlers' transactional income on its profitability is set out in Appendix B. Butlers' revenue streams were very similar to those of STS (see paragraph 2.12). The key difference in relation to transactional income was that Butlers generated this income when clients chose to transact through [ICAP] whilst STS generated this income whenever clients chose to transact through certain third parties (see paragraph 2.12(c)).

2.24 There was a relatively high degree of overlap between Butlers' public authority clients and other areas of ICAP. About half the clients of ICAP's Non-Banking desk (which is involved, among its other activities, in arranging LOBO transactions) were also Butlers' clients. A considerable majority of the clients of ICAP's MyTreasury service (which offers clients an electronic multilateral trading facility for money market funds) were also Butlers' clients. [✂]

2.25 Butlers employed a total of 13 staff to provide TMA services to local authorities and an additional three staff on a consultancy basis. Butlers obtained central function support from ICAP, including IT, Human Resources, Finance and Compliance.

2.26 Butlers' TMA services were focused on three core areas:

(a) debt portfolio management: advising clients on the timing and type of new borrowing, as well as the restructuring of existing debt;

(b) investment services: information on credit counterparties, generic advice on investment in market instruments, term deposits and the optimum length of investments, as well as the appointment and monitoring of external fund managers, ie investment services not subject to FSA regulation (see paragraph 2.5); and

(c) technical services: advising clients in relation to accounting practice and requirements.

2.27 ICAP told us that none of these activities included the provision of regulated investment advice.

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[19] Based on Butlers' data over the last five years, annual retainer revenue ranged from £[✂] to £[✂], with an average annual value of £[✂].
[20] Based on Butlers' data over the last five years, the average value of one-off contracts was £[✂].

3. The merger and the relevant merger situation

Outline of merger situation

3.1 STS completed its acquisition of ICAP's Butlers business on 25 October 2010 for a purchase price equivalent to £[✂]. ICAP also agreed to give STS [✂].[21]

3.2 On completion of the acquisition, the Butlers business was integrated into STS's TMA business which involved the transfer of around [✂] retainer contracts (including both Butlers' local authority and non-local authority clients) and [✂] employees to STS, and the Butlers trading name was no longer used.

3.3 Further details of the sale process, the other key terms of the transaction and the steps taken to integrate Butlers into STS following the merger are set out in Appendix C.

The rationale for the merger

ICAP's rationale

3.4 In October 2008 three Icelandic banks which held considerable deposits from UK local authorities collapsed. In 2009 the Communities and Local Government Select Committee held hearings into local authorities' investment practices and in June of that year published its report which recommended, among other things, that the FSA investigate the services offered by TMA service providers to local authorities. In November and December 2009, the FSA conducted a routine ARROW[22] review of ICAP's subsidiary, ISL.

3.5 [In April 2010,] [f]ollowing a routine ARROW review, the FSA [requested a general review of certain aspects of] [✂] [(including Butlers) ('the Review')].[23] [The Review] completed in September 2010.

3.6 ICAP began a strategic review of Butlers in early June 2010 during the investigation phase of [the Review]'s work, before the recommendations of the [Review] were confirmed. [✂] The [Review's] [✂] recommendations [✂].

3.7 Further details of the background events leading up to [the Review], [the Review]'s recommendations and ICAP's strategic review of Butlers are set out in Appendix D.

3.8 One of the recommendations in the [Review] was that ICAP needed to decide whether Butlers should become authorized by the FSA so that it would be able to give regulated investment advice in the same way as its competitors. During ICAP's strategic review of Butlers, Butlers' management had expressed the view that the continued success of Butlers depended on Butlers being able to provide regulated investment advice (see paragraph 5.35). ICAP told us that it was obvious to ICAP that the cost associated with making Butlers an authorized business would be entirely disproportionate to the benefit of retaining the business.[24] Such expenditure would also have been inconsistent with ICAP's intention of focusing only on its core businesses. During the course of our inquiry, ICAP told us that there were additional reasons that ICAP wished to exit from the Butlers business (see paragraph 5.4), that ICAP took into account during its strategic review. ICAP considered that, following its

[21] [✂]
[22] The Advanced, Risk-Responsive Operating FrameWork, the framework used by the FSA to conduct its risk-based regulation.
[23] [✂]
[24] We note, as set out in paragraph 5.36, that ICAP had not formally calculated these costs.

strategic review, it was 'left with a binary decision: to sell the Butlers business or to shut it down'.

3.9 [✂] ICAP approached STS about a potential acquisition of Butlers in early July 2010 and did not approach any other potential purchasers.

STS's rationale

3.10 STS told us that the opportunity to acquire Butlers was 'consistent with Capita's strategy [✂]. STS told us that 'Butlers satisfied these considerations'.

3.11 In internal documents from October 2010, STS stated that one of its initiatives [✂].

3.12 We noted that, according to STS, ICAP was keen to exit quickly from the Butlers business and [✂]. We considered it likely that the [✂] level of the consideration contributed to STS's decision to purchase Butlers.

Jurisdiction

3.13 Under section 35 of the Act, and pursuant to our terms of reference (see Appendix A), we are required to decide first whether a relevant merger situation has been created by the acquisition by STS of Butlers. Section 23 of the Act provides that a relevant merger situation is created if:

(a) two or more enterprises have ceased to be distinct at a time or in circumstances falling within section 24 of the Act;[25] and

(b) if either the turnover test or share of supply test is met. The turnover test is met if the value of the turnover of the acquired enterprise exceeds £70 million. The share of supply test is met if the enterprises which ceased to be distinct have a share of supply of goods or services of any description in the UK, or in a substantial part of the UK of at least one-quarter, or if one of the enterprises already supplied at least one-quarter, it must have increased its share as a result of the merger.

3.14 Both Butlers and STS carry on activities which are not supplied free of charge. We are therefore satisfied that both Butlers and STS are 'enterprises' for the purposes of section 23 of the Act.

3.15 As set out in paragraph 3.1, STS completed its acquisition of Butlers on 25 October 2010. The OFT's statutory deadline for making a reference under section 24 of the Act, as extended under sections 25(1) and 25(2) of the Act,[26] was 4 April 2011. As set out in paragraph 1.1, the OFT referred the merger to the CC on 31 March 2011. We are therefore satisfied that Butlers and STS ceased to be distinct enterprises at a time or in circumstances falling within section 24 of the Act.

3.16 Section 26 of the Act provides that two enterprises cease to be distinct when they are brought under common ownership. The transaction described in paragraph 3.1

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[25] Two or more enterprises have ceased to be distinct at a time or in circumstances falling with section 24 if they ceased to be distinct not more than four months before the date on which the OFT is to refer the merger to the CC or if notice of 'material facts' about the merger has not been given to the OFT or made public in the manner and at the time set out in section 24(2).
[26] Section 25(1) provides for the extension of the four-month period mentioned in section 24 by mutual agreement between the OFT and the main parties to the merger. Section 25(2) provides for the extension of the four-month period mentioned in section 24 if the OFT considers that any of the main parties to the merger has failed to provide within the period stated in a notice under section 31, information requested in that notice.

resulted in the transfer of Butlers' customer contracts and employees from ICAP to STS which enabled STS to provide TMA services to Butlers' customers. The Butlers trading name is no longer used. We are satisfied that as a result of this transaction the two enterprises were brought under common control and have therefore ceased to be distinct.

3.17 Before the merger, STS and Butlers both supplied TMA services to UK local authorities under retainer contracts. On the basis of the figures set out in Table 1 in Section 6, we estimate that, before the merger, STS had a share of supply of TMA retainer contracts in the UK of [45–55] per cent, while Butlers had [25–35] per cent. As a result of the merger, the share of supply exceeded 25 per cent. We are therefore satisfied that the share of supply test is met and, as a result, we are not required to consider the value of the turnover of the acquired enterprise. We are also therefore satisfied that a relevant merger situation has been created and the first statutory question in section 35 of the Act (see paragraph 1.1) has been answered.

4. Market definition

4.1. The CC's merger assessment guidelines[27] (the Guidelines) state that the purpose of market definition in a merger inquiry is to provide a framework for the analysis of the competitive effects of the merger. The Guidelines go on to state that the CC and OFT will identify the market within which the merger may give rise to an SLC, and that this will include the most relevant constraints on behaviour of the merger firms.

4.2. The Guidelines also note that in practice, the analysis leading to the identification of the market or markets and assessment of competitive effects will overlap, with many of the factors affecting market definition being relevant to the assessment of competitive effects and vice versa.[28] In this section we set out the main parties' views on the relevant market, we identify the relevant market in which we have assessed the effects of the merger and we signpost where we have dealt in our competitive assessment with the issues raised by the main parties in the context of market definition.

Views of main parties

4.3. In its Initial Submission, ICAP noted that in the OFT's decision to refer the STS/Butlers merger to the CC, the OFT had concluded that the relevant product market was that for retained TMA services to local authorities and that the relevant geographic market was national. ICAP did not comment further on market definition.

4.4. STS argued in its Initial Submission that the relevant product market:

(a) included the supply of TMA services to all public sector customers. STS did not consider it appropriate to define narrower product markets for particular categories of public sector customer (eg local authorities or housing associations) because the same underlying TMA services were provided to all such categories of customer using the same transferable skill set; and

(b) included TMA services supplied both on a retained and a one-off basis. This was because customers could, STS submitted, determine the mix of TMA services they wished to procure on a retained and one-off basis respectively. STS noted that providers which did not currently compete actively to supply retained TMA

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[27] Merger assessment guidelines, CC2 (revised), September 2010, paragraph 5.2.1.
[28] The Guidelines, paragraph 5.1.1.

services across the board were able—and competed—to supply many TMA services generally included in retainer contracts.

4.5. Further, STS argued that competitors were constrained by the ability of customers to self-supply. STS submitted that budgetary constraints in the public sector meant that public spending on external consultants was under scrutiny and a number of customers had chosen to reduce the scope of services obtained from STS and to rely to a greater extent on internal resources to satisfy their TMA service needs. STS believed that a significant proportion of public sector customers ([5–15] per cent of local authorities) did not currently obtain TMA services from external suppliers.

4.6. STS stated in its Initial Submission that it considered the appropriate geographic market to be the UK.

The relevant market

4.7. STS and Butlers both provided TMA services to UK[29] local authorities under retainer contracts and these are the services that may be affected most directly by any loss of competition following the acquisition.[30] The main parties also overlapped in the supply of one-off contracts for TMA services to UK local authorities. However, our analysis showed that one-off contracts were in most cases arranged with the supplier of the existing TMA retainer contract and that we had no reason further to consider separately the impact of the merger upon them (see Appendix F).

4.8. Our analysis shows that the supply of TMA services on a retainer basis is an appropriate choice of relevant market as this market includes the most relevant constraints on the behaviour of the main parties. Our analysis of competitive effects and entry demonstrate that this market satisfies the hypothetical monopolist test (HMT).[31] Section 6, Appendix F and Appendix H of this report suggest that, relative to the pre-merger situation, the merger would enable the main parties to raise the price of their retainer contracts for TMA services to UK local authorities without eliciting sufficient demand or supply response to defeat that price rise. We included consideration of the points raised by STS listed in paragraphs 4.4 and 4.5 in this assessment.

4.9. On the basis of this analysis we therefore concluded that the supply of TMA services to UK local authorities under retainer contracts was the relevant market for the purposes of our inquiry.

5. The counterfactual

5.1 We considered what was likely to have happened in the absence of the merger ('the counterfactual').[32]

[29] Neither STS nor Butlers had contracts to supply TMA services in Northern Ireland.
[30] STS argued that the underlying TMA service provided to police authorities, fire authorities and other similar public sector organizations was the same as that provided to local authorities. STS therefore considered that the relevant market should include these types of customer. We have defined a market that includes the most relevant constraints on the behaviour of the merger firms. The fact that police authorities, fire authorities etc obtain similar TMA services to local authorities does not alter our competitive assessment. This is because, although STS and Butlers overlapped in the supply of TMA services to local authorities and other types of authority, we found that they were not constrained by suppliers of TMA services which only provided services to these other types of authority. The inclusion or exclusion of these other types of authority in the relevant market would not alter the outcome of the inquiry.
[31] The Guidelines, paragraph 5.2.8 states 'The Authorities use the 'hypothetical monopolist test' as a tool to check that the relevant product market is not defined too narrowly'. The HMT is satisfied if a monopoly supplier of the products or services in question would be able profitably to raise prices to some customers by at least 5 per cent.
[32] The Guidelines, paragraph 4.3.1, states: '[t]he application of the SLC test involves a comparison of the prospects for competition with the merger against the competitive situation without the merger. The latter is called the 'counterfactual'.

Views of main parties

5.2 Both STS and ICAP argued that the most likely counterfactual was the closure of Butlers.

5.3 In its Initial Submission, ICAP told us that absent the merger, 'it was both foreseeable and certain that ICAP would have shut down [Butlers]' and that the majority of its staff and client base would have migrated to STS. It gave the following reasons for wishing to exit from the Butlers' business:

(a) Butlers was a 'legacy, non-strategic and non-material business for ISL' and irrelevant to ICAP from a financial point of view.

(b) Incurring costs (as would have been necessary to allow Butlers to provide regulated investment advice) in relation to retaining Butlers would have been inconsistent with ICAP's announced intention to focus on its core brokerage business.

(c) ICAP told us that it had 'calculated that the cost of the necessary expenditure to retain' Butlers would have been disproportionate to the benefit of its retention.

5.4 ICAP expanded on these reasons at its hearing with us and in its further submissions to us following the hearing. It emphasized that its decision on the retention or sale of Butlers was a commercial decision and was not based solely on financial considerations. It explained that, in addition to the recommendation[s] [in the Review] [✂], there were additional factors as well:

(a) Butlers' financial performance was deteriorating,[33] and, although it was not loss-making, if transactional income is excluded, it was at a 'break even' position for FY2010. Butlers' staff considered that the only way to improve Butlers' performance (particularly in light of criticism from clients for its inability to provide regulated investment advice) was to allow Butlers to provide such advice.

(b) The management action and expenditure necessary to retain Butlers and allow it to provide regulated investment advice would have been a distraction from ICAP's strategic focus on its core brokerage business and the broader regulatory challenges ICAP was facing across its business. The financial costs of retaining Butlers, whilst they may not have been large in absolute terms, would have been out of proportion to the benefits of retention;

(c) Butlers had brought unfavourable publicity to the wider ICAP group following the Icelandic banking crisis.

(d) As ICAP had no desire to reinvest in Butlers, the likely closure costs (see Appendix D) would not have deterred ICAP from closing the business.

(e) Butlers had management succession issues. The second tier of Butlers' management (who would have remained after more senior managers had departed) had not been able to produce a compelling business plan for Butlers when requested.

5.5 ICAP told us in the hearing that, in the absence of a sale of Butlers to STS, ICAP would have immediately made a decision to close Butlers, and would then have gradually wound the business down to allow a managed exit.

[33] We noted that, as set out in Appendix B, Butlers' operating profit (excluding transactional income) declined year-on-year from around £[✂] in FY2007 to £[✂] in FY2010. This period of time covered the Icelandic banking crisis in 2008 and its aftermath.

5.6 In its Initial Submission, STS told us that when ICAP approached it regarding a possible acquisition of Butlers, ICAP told it that 'ICAP's Board had decided to exit the advisory business as a result of [regulatory issues]'. STS also told us that ICAP told it at the time of the sale negotiations that, if a sale to STS was not possible, ICAP would close Butlers.

Views of third parties

5.7 Arlingclose was the only third party that expressed a strong view on the likely counterfactual. It told us that

> '[i]t is… clear that at least two alternative and realistic counterfactual scenarios exist which would have had a less detrimental effect on competition than the merger – first, that some or all of the Butlers business could have been acquired by Arlingclose and, secondly, that the Butlers portfolio of local authority contracts could have been terminated or lapsed upon Butlers' exit, with the needs of those local authorities then met through competition for them among all of the other remaining players in the market.

Our assessment

5.8 We considered that, absent the merger, ICAP had the following options available to it in relation to the Butlers business:

(a) exit by sale to an alternative purchaser;

(b) exit by closure (whether immediate or gradual); or

(c) retention of the Butlers business within ICAP, with or without the ability to provide regulated investment advice.

5.9 We examine each of these possibilities in the following sections.

Alternative purchasers

5.10 The Guidelines state that, when considering the prospects for alternative purchasers:

(a) the CC will assess the evidence supporting the claims that there was only one possible purchaser for the firm or its assets; and

(b) the unwillingness of alternative purchasers to pay the vendor the asking purchase price would not rule out a counterfactual involving a sale to an alternative purchaser.[34]

ICAP's view on alternative purchasers

5.11 In June 2010, at the start of its strategic review of Butlers, ICAP identified STS as a potential purchaser because Butlers' senior management had said that STS would be the 'most interested' in acquiring Butlers' clients and staff.[35]

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[34] The Guidelines, paragraph 4.3.17.
[35] At this stage, Butlers' senior management was not reported as saying that STS was the *only* purchaser.

5.12 ICAP's assessment of the legal risks of the transfer of the Butlers business to STS dated 1 October 2010 stated that senior members of ICAP and Butlers 'agreed that STS was the only suitable candidate and no other firm was identified as an appropriate alternative'. We noted that this document was prepared after ICAP had already made the decision to sell Butlers to STS and on the day the Butlers transfer agreement was signed.

5.13 In its Initial Submission, ICAP told us that 'ICAP management considered STS to be the only entity with the capacity and ability to acquire and integrate the Butlers business (particularly with regard to the transfer of, and optimal environment for, clients and employees) and approached it directly to inquire as to its interest'.

5.14 ICAP added that

> There was no public sale or tender process for the disposal of the Butlers business. This was not deemed necessary, as ICAP viewed STS as the only realistic and viable purchaser, given the pressure from the FSA to respond to the [Review]. The practical alternative would have been to terminate the employment of the staff, at considerable cost to ICAP, and risk the majority going en masse to work for Sector [STS] anyway.

Our assessment

5.15 It is clear that, having sought and received interest from STS, ICAP did not consider it necessary to approach alternative purchasers. However, in our assessment of the counterfactual, we must consider what would have been likely to happen, had a sale of Butlers to STS not been an option open to ICAP.

5.16 The contemporary documents, the other evidence ICAP provided to us and the surrounding context indicate that ICAP would have attached importance to the following factors in seeking an alternative purchaser for Butlers:

(a) Avoiding a drawn-out sales process, in light of the need to respond to the recommendations in the [Review] [✄][36] and ICAP's desire not to generate further uncertainty for Butlers' staff and clients, following the Icelandic banking crisis.

(b) Finding a reputable purchaser with the ability to employ Butlers' staff on terms acceptable to those staff and maintain the quality of the services offered to Butlers' clients. This was because ICAP was mindful of its relationships with Butlers' clients across other parts of its business and was keen to avoid any damage to these relationships as a result of the sale of Butlers.

(c) Achieving a comprehensive solution, satisfactory to the FSA and leaving no residual Butlers' regulatory issues for ICAP to deal with.

5.17 We considered the likelihood of a management buyout (MBO). We asked four former Butlers' employees whether they were aware of any plans, or had any appetite, for an MBO of the Butlers business from ICAP. Although a variety of reasons was given for each response, the evidence from these former Butlers' employees was that, absent the merger, an MBO was unlikely. We therefore did not pursue this possibility further.

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[36] [✄]

5.18 We asked a number of third parties whether they would have been interested in acquiring Butlers. Three parties expressed an interest: Sterling, Deloitte LLP (Deloitte) and Arlingclose.

Sterling as an alternative purchaser

5.19 Sterling[37] told us that it would have been interested and able to acquire Butlers. We considered that a key issue in assessing the likelihood of Sterling acquiring Butlers was the scale of the Sterling TMA services business and its positioning in the market:

(a) Our analysis (as set out in paragraphs 6.7 and 6.8) indicates that Sterling was not as strong a competitor in the market before the merger as STS, Butlers and Arlingclose. It has not grown aggressively since its launch in 2000 and its position in the market has remained relatively static over the last five years.

(b) Whilst Sterling employs around [✂] staff, its Consultancy division employs a team of [✂] providing TMA services to 27 local authority clients. Sterling told us that specifications of each Butlers' contract, and the number and skills-set of the Butlers' employees transferring over to Sterling, would have determined how many contracts Sterling would have been able to take on. A partial sale of Butlers would have been likely to be unsatisfactory to ICAP, given that we considered that ICAP was seeking (among other things) a comprehensive solution to the regulatory issues that had been identified with Butlers (see paragraph 5.16).

(c) An acquisition of Butlers by Sterling would have been likely to involve the integration of a much larger Butlers business (which had suffered from poor publicity following the Icelandic banking crisis as well as declining profitability and management succession issues) into Sterling's TMA services business.

5.20 These factors would have been likely, in our view, to have raised ICAP's concerns that Sterling might not be able to maintain its service quality across the full range of Butlers' clients and that ICAP's reputation would be damaged as a consequence. We therefore concluded that, whilst Sterling may have had the appetite to acquire Butlers, the risks of a sale to Sterling would have been perceived by ICAP to be sufficiently high to make a sale of Butlers to Sterling unlikely.

Deloitte as an alternative purchaser

5.21 Deloitte told us that, had it been approached about purchasing contracts and transferring staff from Butlers, it would have considered the possibility, but would not have taken the matter further without detailed and thorough due diligence to assess the business and whether such a deal would be appropriate for Deloitte. We noted that [✂]. It told us that, in providing TMA services, [✂]. We therefore did not consider Deloitte to be a realistic alternative purchaser of Butlers absent the merger.

Arlingclose as an alternative purchaser

5.22 In its Initial Submission, ICAP told us that Arlingclose 'was also briefly considered as a potential purchaser, but [was] rejected for a number of objective reasons (all of which were related to ICAP's concern that the clients of Butlers would not get an adequate service from Arlingclose)'. ICAP's reasons are set out in Appendix E.

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[37] Sterling is majority-owned by Skipton Building Society. It is primarily a money broker but also provides TMA services to the public sector through its consultancy division.

5.23 In contrast, Arlingclose told us that, if it had been approached by ICAP about a possible acquisition of Butlers, it would have been interested. The publicly announced purchase consideration of less than £100,000 would not have deterred it, and it would have regarded a possible purchase of Butlers as an opportunity to enhance its business. Arlingclose stated that

> Arlingclose would have been interested in acquiring a representative proportion of the Butlers business with reference to fee income. Arlingclose could have absorbed up to 30 additional Local Authority mandates without requiring additional staff. However we would also have considered taking up to 100% of Butlers business and arguably the majority of the 6 staff who transferred to Sector [STS].

5.24 Notwithstanding the lack of evidence indicating that ICAP had assessed Arlingclose as a potential purchaser prior to selling Butlers to STS, we assessed the reasons given by ICAP in its Initial Submission as to why it did not consider Arlingclose to be a suitable purchaser.

5.25 We asked Arlingclose how it would respond to ICAP's concerns set out in its Initial Submission, in relation to the suitability of Arlingclose as an alternative purchaser of Butlers. Arlingclose submitted a detailed response which addressed each of ICAP's concerns. Further details of Arlingclose's response are set out in Appendix E.

5.26 We concluded that ICAP had not conducted a sufficiently in-depth assessment of Arlingclose's services to assert that Arlingclose's offering to Butlers' customers would have been inferior to that of STS.

Conclusion on alternative purchasers

5.27 We did not rule out Arlingclose as a viable alternative purchaser of Butlers, if ICAP had not sold Butlers to STS. However, in light of the issue with competitive effects identified in the next paragraph, it was not necessary for us to carry out a detailed assessment to establish whether a sale to Arlingclose was the most likely alternative to the merger. We did not find any other viable alternative purchasers.

5.28 Given the shares of supply of retainer contracts set out in Table 1, we considered it likely that the OFT would have jurisdiction in relation to a sale of Butlers to Arlingclose.[38] As a result of the assessment set out in paragraphs 6.6 to 6.10, we believed that a sale of Butlers to Arlingclose would have been likely to raise sufficient concerns about competition that it would have been referred by the OFT to the CC for investigation.[39] As such, we were satisfied that it would not be appropriate to adopt a sale to Arlingclose as the counterfactual to the merger. Therefore, to conclude on the appropriate counterfactual, we considered which was the most likely of the remaining options, ie we examined whether closure or retention of Butlers by ICAP was more likely.

Would ICAP have closed or retained Butlers?

5.29 We would not normally expect a company to close a profitable subsidiary or division as this would involve incurring closure costs as well as foregoing future profits. How-

[38] Paragraph 3.13 explains the circumstances in which a relevant merger situation is created.
[39] The Guidelines, paragraph 1.9 explains that, under sections 22 and 33 of the Act, 'the OFT has a duty to refer to the CC for further investigation any relevant merger situation where it believes that it is or may be the case that the merger has resulted or may be expected to result in an SLC'.

ever, we accept that this may be rational in exceptional circumstances where there are compelling strategic reasons for closure.

5.30 In this case, the main parties did not argue that Butlers was failing in financial terms. As the figures in Appendix B show, Butlers was profitable and there was no compelling evidence (even allowing for possible increases in costs) that it would have become intrinsically unprofitable in the future. In contrast, closure of Butlers entailed ICAP foregoing Butlers' future profits and incurring significant costs. Indeed, the sale of Butlers to STS for a price that could be considered to be below the apparent value of the business to ICAP tends to support ICAP's argument that its decision on the future of Butlers was not based on purely financial considerations. We therefore examined the broader context in which ICAP took its decision about Butlers.

5.31 On the basis of evidence from ICAP (including contemporaneous internal documents) and our own [understanding of the outcome of the Review], we found that, as argued by ICAP:

(a) ICAP's strategic review of Butlers was undertaken in the context of the [Review] and its likely recommendations, [✂]; and

(b) the timing of the Review and its surrounding context resulted in close scrutiny of Butlers by ICAP management. ICAP management formed a view that a decision over the future of Butlers was a matter of urgency (even if the eventual decision might be implemented over time).

5.32 We consider that a number of factors contributed to ICAP's decision on whether it was commercially rational to retain or dispose of Butlers.

5.33 First, ISL considered Butlers to be a 'non-strategic and non-material business'. This was supported by other evidence, including:

(a) Butlers and TMA services were given no mention in ISL's FY2009 and FY2010 Summary Annual Reports, nor in ICAP's FY2009 and FY2010 Annual Reports; and

(b) Butlers accounted for a very small proportion (less than [0–10] per cent) of ISL's total revenues (see paragraph 2.20).

5.34 Second, Butlers' profitability was declining. Our analysis showed that Butlers' profitability (excluding transactional income) had been declining year-on-year, from around £[✂] in FY2007 to around £[✂] in FY2010. Although Butlers' apparent profitability could have been improved by reducing bonuses, or including transactional income in the calculation, our assessment did not take into account any future impact on Butlers' profitability as a result of any change in its ability to win tenders or generate transactional income if ICAP had retained Butlers and implemented the necessary controls recommended by the [Review].[40]

5.35 Third, although ICAP had considered options for retaining Butlers, one of the most plausible options[41] would have entailed allowing Butlers to provide regulated investment advice:

[40] Two recommendations in the [Review] that may have affected Butlers in this way were [✂].
[41] Another option considered during ICAP's strategic review of Butlers involved retention by ICAP of the debt portfolio management consultancy service of Butlers with the remaining parts of Butlers being transferred to STS. At this point in time (August 2010), ICAP had recently been made aware of the [Review's] recommendations and ICAP had been discussing the sale of Butlers with STS since July 2010. Because STS did not find this proposal commercially attractive, this option was subsequently abandoned by ICAP.

(a) The second tier of Butlers' management had as part of its draft 2010 Business Plan (dated May 2010) included proposals for seeking permission from the ISL Board to allow Butlers to begin giving regulated investment advice.

(b) During ICAP's strategic review of Butlers, an internal email on 12 August 2010 stated that 'an increasing number of local authorities [are] expecting us to provide [regulated] investment advice. The Chairman of the [Butlers] business considers that the continued success of the business will require investment advice to be provided'.

5.36 ICAP told us that the proposal by Butlers' management for Butlers to provide regulated investment advice was not finalized or approved by Butlers' senior management, and was not presented to the ISL Board since the [Review] had made ICAP aware of 'how expensive it would be to enable Butlers to provide regulated investment advice, and caused ICAP to conclude that the only viable commercial solution was to sell the business'. We note that ICAP had not formally calculated these costs.

5.37 ICAP told us that it

> did not feel a need to carry out a formal calculation of costs (whether for expanding the scope of Butlers' advice or for continuing with its existing model). It was self-evident to those responsible for running the Butlers business – from both the strategic review of the Butlers business undertaken at the request of ICAP senior management, and the [Review] following the FSA's ARROW review – that the steps required for either option involved greater investment than ICAP was willing to undertake. This was particularly the case given the size of the business (Butlers did not make a material contribution to the ICAP group) and its recent reputational issues'.

5.38 Fourth, Butlers had management succession issues. We were told by ICAP that four senior members of Butlers had, prior to the merger, indicated their intention to retire or to reduce their working time. This was confirmed by Butlers' ex-Executive Director in the context of his evidence to us on the feasibility of an MBO, absent the merger (see paragraph 5.17).

5.39 We do not know how these management changes would have affected Butlers' business performance in the foreseeable future. We considered that a succession plan could have been put in place. However, we accepted, in light of both the seniority and experience of the staff concerned and the evidence about the difficulties TMA service providers had in obtaining sufficiently experienced and qualified staff (see Appendix H), that developing and implementing an effective succession plan would have required significant ICAP managerial input.

5.40 Crucially, over and above the four contributing factors set out in the preceding paragraphs, it was clear to us that the issues raised in the [Review] underpinned ICAP's decision. The review was wide-ranging and its recommendations presented ICAP senior management with a series of governance and compliance challenges [✂]. As a result, senior ICAP management formed the view that management time had to be focused on key business areas, and Butlers was not a priority. Further, although not substantial in themselves, addressing the issues identified in the [Review] in relation to Butlers would itself have absorbed management time and risked eroding Butlers' future ability to win clients and generate transactional income. [✂]

Conclusions on whether ICAP would have closed or retained Butlers

5.41 In this case, we considered that there were a number of exceptional circumstances surrounding the merger (see paragraphs 5.33 to 5.40) that affected ICAP's decisions, such that on the balance of probabilities, it would have been commercially rational for ICAP to close Butlers rather than retain it, in the absence of a sale to STS. This would have been consistent with a managed exit over time, as ICAP told us would have been the case, designed to mitigate any damage to the rest of ICAP's business from the loss of its TMA relationships with Butlers' clients. ICAP told us that its likely compliance costs over a period of phased exit would have been manageable.

Conclusions on the counterfactual

5.42 To determine what was likely to have happened to Butlers had it not been sold to STS, we assessed the three options open to ICAP in relation to Butlers:

(a) exit by sale to an alternative purchaser;

(b) exit by closure (whether immediate or gradual); or

(c) retention of the Butlers business within ICAP, with or without the ability to provide regulated investment advice.

5.43 Whilst Arlingclose told us that it would have been interested in acquiring a part of, or possibly all of, Butlers' contracts and staff, and we considered that Arlingclose would have been a viable purchaser, it was not necessary for us to carry out a detailed assessment to establish whether a sale to Arlingclose was the most likely alternative to the merger. This was because we believed that a sale of Butlers to Arlingclose would have been likely to raise sufficient concerns about competition that it would have been referred by the OFT to the CC for investigation. We therefore did not pursue further a counterfactual in which Arlingclose acquired Butlers. We did not identify any other viable alternative purchasers. As a consequence, our analysis focused on the question of whether ICAP would have retained or closed Butlers in the absence of the merger.

5.44 Butlers was not failing financially. However, the evidence showed that ICAP faced wide-ranging regulatory pressures that, in combination with other strategic issues facing the Butlers business and in these particular and exceptional circumstances, made it commercially rational for ICAP to close Butlers rather than retain it, in the absence of a sale to STS.

5.45 We therefore concluded that the counterfactual was that ICAP would have immediately made a decision to close Butlers, and would then have gradually wound down its contracts with a view to full exit in the foreseeable future.

6. Assessment of the competitive effects of the merger

Theories of harm

6.1 The Guidelines explain theories of harm (TOH) as follows:[42]

[42] The Guidelines, paragraph 4.2.1.

> Theories of harm are drawn up by the Authorities to provide the framework for assessing the effects of a merger and whether or not it could lead to an SLC. They describe possible changes arising from the merger, any impact on rivalry and expected harm to customers as compared with the situation likely to arise without the merger….

6.2 In our issues statement,[43] we identified one TOH, which was that the acquisition of Butlers by STS had reduced the number of companies competing to provide TMA services to local authorities in a way that was likely to lead to increased prices or deterioration in the quality of services. During our inquiry, we also identified another TOH, namely that, even if the merger did not reduce the number of competitors compared with the counterfactual, differences in the market share distribution as a result of the merger would allow STS to increase its prices or worsen other aspects of its retail offer.[44]

6.3 In this section, we set out our analysis of these TOH.

The framework for our assessment of competitive effects

6.4 To assess whether there has been an SLC as a result of the merger, we compared competition in the relevant market following the merger with competition in the market in the counterfactual, in which ICAP would have closed Butlers by gradually winding down its contracts.

6.5 Before we compared the merger with the counterfactual, we explored the effect on competition of a sale of Butlers to either STS or Arlingclose compared with pre-merger conditions. This allowed us to understand both *(a)* the incentives of STS following the merger, and *(b)* whether it was open to us to adopt a sale to Arlingclose as the counterfactual, had we decided that this was the most likely alternative to the merger.[45] We looked at the evidence on the dimensions of competition (ie the aspects of TMA services on which market participants compete), the closeness of competition between market participants before the merger and the size of variable profit margins.

Dimensions of competition

6.6 In light of the evidence set out in Appendix F, we found some differentiation between the market participants in terms of price and quality of the services provided. Sterling in particular appeared to be perceived as being an average-quality, low-price provider during the bidding process. We consider whether this generates any competition concerns in relation to particular customer segments as a result of the merger in paragraph 6.19.

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[43] www.competition-commission.org.uk/inquiries/ref2011/Sts_Butlers/pdf/110426_ssues_statement.pdf.
[44] Arlingclose argued that we should have considered another TOH, namely that the merger further allowed STS to cross-subsidize its retainer fee levels with its transactional income (see paragraph 2.12) and adopt predatory pricing techniques to drive the remaining two competitors from the market. Arlingclose told us that cross-subsidization was not an option that was available to Arlingclose because its business model was based on offering independent advice free from conflicts of interest and accordingly it did not receive transactional income. However, although we found that STS did receive transactional income, we did not consider that the merger had changed the ability or incentives in the market to engage in cross-subsidization compared with the counterfactual. For this reason, we did not consider this to be a merger-related TOH. Further, the Competition Act 1998 provides for the investigation of anticompetitive practices (including predatory pricing) by the OFT. We did not see any evidence which caused us to form a preliminary view that predatory pricing was occurring.
[45] As set out in paragraph 5.27, we concluded that Arlingclose was the only viable purchaser of Butlers in the absence of the merger.

Closeness of competition

6.7 In relation to closeness of competition in the relevant market before the merger, we found that:

(a) our diversion ratio[46] analysis indicated that Arlingclose captured most of the switching from both Butlers and STS with STS being the second closest competitor to Butlers and Butlers the second closest competitor to STS. This result appeared at least in part to be due to the sharp rise in the competitive strength of Arlingclose as it built on its enhanced reputation following the Icelandic banking crisis in 2008;[47]

(b) Butlers ranked most often as the second bidder when STS won and, similarly, STS ranked most often as the second bidder when Butlers won. This result was consistent with the pre-merger market shares of STS and Butlers (see Table 1); and

(c) historic market share data showed that the importance of Arlingclose as a competitive constraint on STS and Butlers had increased over time as Arlingclose increased its market presence.

6.8 The evidence we gathered on closeness of competition suggested that Arlingclose, STS and Butlers were all very close competitors before the merger.

Margin analysis

6.9 We considered evidence on variable profit margins. The Guidelines state that '[i]f the variable profit margins of the products of the merger firms are high, unilateral effects are more likely because the value of sales recaptured by the merged firm will be greater, making the price rise less costly.'[48]

6.10 As set out in Appendix F, we estimated likely ranges for the gross variable margins of STS, Butlers and Arlingclose and found them to be moderately high to very high. We combined these margins with our moderate estimates of diversion ratios, and carried out a GUPPI[49] analysis. Considering this analysis alongside the other evidence on competitive effects, we found that:

(a) following the merger, STS would have at the very least a moderate incentive to raise prices or worsen other aspects of its retail offer compared with pre-merger conditions; and

(b) in so far as such an analysis was possible (see the second footnote to paragraph 6.7(a)), if Arlingclose had acquired Butlers, Arlingclose would also have had at the very least a moderate incentive to raise prices or worsen other aspects of its retail offer compared with pre-merger conditions (considering the GUPPI analysis for Butlers assuming it had been sold to Arlingclose, as set out in Appendix F, Annex 2). Together with the other evidence about the strength of Arlingclose's

[46] The diversion ratio is the proportion of customers lost from one service who switch to a competing service.
[47] As set out in Appendix F, Annex 1, we were able to undertake a diversion ratio analysis for switching away from Butlers to Arlingclose but when we tried to undertake a diversion ratio analysis for switching away from Arlingclose, there were too few observations to produce reliable results.
[48] The Guidelines, paragraph 5.4.9(b).
[49] GUPPI refers to Gross Upward Price Pressure Index. The GUPPI analysis combines diversion ratios, variable margins and relative prices to provide an indication of the extent of pre-merger competition between parties.

competitive position set out in paragraphs 6.6 to 6.9 and Appendix F,[50] we considered this to be sufficient to prevent us adopting a sale to Arlingclose as the counterfactual on the grounds that such a sale would have been likely to be referred by the OFT to the CC for investigation.

The competitive effects of the merger

6.11 To assess the competitive effects of the merger in comparison with the counterfactual, we assumed that, in the counterfactual, Butlers' contracts would have been retendered over a period of years as existing contracts expired.[51] On retendering, we assumed that they would have been distributed around the remaining market participants according to the historic pattern of bidding success in the market as indicated by the diversion ratios we calculated from the data provided to us by the market participants (see Appendix F).[52] The distribution of market shares following the merger and in the counterfactual are shown in Table 1 (alongside the pre-merger distribution and the distribution if ICAP had sold Butlers to Arlingclose).

TABLE 1 **Distribution of market shares**

	Before the merger		*Following the merger*		*Counterfactual*		*Arlingclose buys Butlers*	
	Number of contracts	*%*	*Number of contracts*	*%*	*Number of contracts*	*%*	*Number of contracts*	*%*
Arlingclose†	[✂]	[15–25]	[✂]	[15–25]	[✂]	[25–35]	[✂]	[45–55]
Butlers†	[✂]	[25–35]						
STS†	[✂]	[45–55]	[✂]	[75–85]	[✂]	[55–65]	[✂]	[45–55]
Sterling†	[✂]	[5–15]	[✂]	[5–15]	[✂]	[5–15]	[✂]	[5–15]
Total	[✂]	100	[✂]	100	[✂]*	101*	[✂]	100

Source: Arlingclose, Butlers, STS, Sterling and CC analysis.

*Sums to more than [✂] (100 per cent) due to rounding.
†Numbers from detailed contract datasets provided by the parties which may differ slightly from the headline number of contracts for each party quoted elsewhere in this report.

6.12 Following the merger, the number of market participants has declined from the four that existed pre-merger (STS, Butlers, Arlingclose and Sterling) to three (STS, Arlingclose and Sterling). However, this would also have been the case in the counterfactual. The merger has not therefore caused a reduction in the number of market participants compared with the counterfactual.

6.13 STS's market share following the merger is somewhat higher than it would have been had Butlers exited gradually as envisaged in the counterfactual. However, Arlingclose's steady growth and future growth plans were evidence that, once an operator was present in the market, it could grow irrespective of its existing market share. Arlingclose, STS and Butlers have been able to compete strongly in the past despite differences in market shares. As a result, we concluded that future competition was unlikely to be significantly affected in comparison with the counterfactual merely as a result of differences in the size of competitors' market shares.

[50] This evidence includes the relative lack of differentiation between Arlingclose's, Butlers' and STS's services, the fact that Arlingclose captured most of the switching from Butlers (and STS) before the merger and historic market share data showing the increasing importance of Arlingclose as a competitive constraint on Butlers (and STS).
[51] The termination dates in the existing Butlers' contracts would represent an upper bound on the duration of any wind down period. In practice, we considered it likely that the wind down period could be significantly shorter than this, if ICAP took steps to negotiate earlier termination dates or clients sought new TMA service providers proactively.
[52] This was the best approximation available to us regarding the distribution of market shares in the counterfactual. We were conscious that historic diversion ratios might overstate likely diversion to Arlingclose, because Arlingclose had benefited from an enhanced reputation following the Icelandic banking crisis in 2008 and this effect might be declining over time.

6.14 However, there is one potentially significant difference between the merger and the counterfactual, arising from the differences in timing of the retendering of Butlers' existing contracts. Following the merger, all Butlers' contracts were immediately transferred to STS. This allows STS to develop relationships with the former clients of Butlers and build up any incumbency advantage that may exist before their contracts come up for retender in the normal course of events. In the counterfactual, Butlers' contracts would gradually be retendered over a period of time, without the opportunity for any of the remaining market participants to build up any such incumbency advantage.

Incumbency advantages arising from local authority inertia

6.15 We considered whether the pattern of award of TMA services contracts showed that, when local authorities retendered their contracts, they were more likely than would otherwise be the case to award contracts to the incumbent TMA service provider. The effect of such inertia could be to relax the competitive pressure on the incumbent to offer a good deal. Specifically, following the merger, it might allow STS to make a less attractive bid than in the counterfactual when Butlers' contracts were retendered.

6.16 Data from our local authority questionnaire showed that both STS and Arlingclose retained about three-quarters of their contracts over time at retendering. The data also showed that around one-quarter of local authorities rolled over their contracts rather than retendering them when the contract term came to an end. Such a practice further benefits the incumbent provider by delaying the time when contracts are subject to competition. Details of our analysis are in Appendix F.

6.17 The evidence indicated that, once a local authority had established a good relationship with a TMA service provider, it might look more favourably on that provider in any retendering process. For about one-quarter of contracts, the incumbent provider might also benefit from a rollover of its contract at the end of its original contract term.

Regional effects

6.18 We considered whether the merger could raise competition issues in some regions of the UK, even if we found that the merger did not lead to an SLC at a UK level. If STS and Butlers were the only two companies serving particular regions of the UK prior to the merger, the merger would have removed competition in that region compared with pre-merger conditions. In the counterfactual, competition in that region might not be removed, if the Butlers' contracts in that region were won by Arlingclose or Sterling. However, as set out in Appendix F, there were no regions of the UK served by only STS and Butlers. In light of this and the evidence from Sterling and Arlingclose about the only modest importance of having a pre-existing regional presence in order to win contracts in that region (also set out in Appendix F), we concluded that the merger was unlikely to lead to an SLC in a particular region or area of the UK in comparison with the counterfactual.

Competition for customer segments

6.19 We also investigated whether the four market participants provided the same depth and breadth of services before the merger, or whether they focused on particular types of customer. In particular, we explored whether some local authorities might be left with little choice of TMA service provider following the merger, because of the type of TMA services they required, and whether this would have been any different in the counterfactual. Details of the evidence we considered are set out in Appendix F.

6.20 We concluded that the number of TMA providers offering a large variety of services has not changed as a result of the merger when compared with the counterfactual. Therefore we found that the merger had not resulted in a loss of competition for particular customer segments.

Conclusions on competitive effects

6.21 Following the merger, the number of market participants has declined from four to three, and this would also have happened in the counterfactual. Although the distribution of market shares would be different in each case, there would remain two strong competitors (ie STS and Arlingclose) bidding for TMA services contracts in both cases. The evidence suggested that the size of these competitors' market shares (which would be different following the merger and in the counterfactual) would be unlikely in itself to result in different degrees of bidding success compared with the counterfactual or differences in the strength of the competitive constraint they applied to other market participants.

6.22 In relation to the retendering of Butlers' contracts, we found that STS would benefit following the merger from the inertia of ex-Butlers' local authorities in awarding their TMA service contracts.[53] STS would have the opportunity to build a relationship with ex-Butlers' clients prior to any retendering process. In the counterfactual, STS would not have that opportunity. This could potentially allow STS to make less attractive bids following the merger than in the counterfactual when Butlers' contracts were retendered. This would be to the detriment of the three-quarters of Butlers' local authority clients that STS would be likely to retain following retendering (see paragraph 6.16). However, the following factors mitigate this effect:

(a) As Butlers' clients did not choose to become STS's clients and STS inherited these contracts part way through their term (ie STS did not have the entire contract period in which to build up a relationship with the client prior to retendering), the extent of STS's incumbency advantage following the merger in relation to such clients might be lower at retendering than suggested by our analysis of historic data.

(b) STS's incumbency advantage following the merger would reduce over time, as about one-quarter of all contracts tend to change hands at each retendering (and this proportion may increase over time, particularly if local authorities react to any attempt by the incumbent provider to worsen its offer)[54].

6.23 We found that the merger had not resulted in a loss of competition in a particular region or area of the UK, nor had it resulted in a loss of competition for particular customer segments, in comparison with the counterfactual.

6.24 Overall, we concluded that the merger was likely to cause a small reduction in competition compared with the counterfactual in relation to those Butlers' contracts that would be renewed through retendering, through the mechanism described in paragraph 6.22. Given the small overall size of the relevant market, we believed that the impact of this small reduction in competition was likely to be minor.

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[53] STS and Arlingclose (and, to a lesser extent, Sterling) would also benefit from an incumbency advantage when their own existing contracts were retendered, but this would be the same following the merger and in the counterfactual.

[54] STS argued that the factors set out in paragraphs 6.22(a) & 6.22(b), together with what it considered to be other constraints on STS's conduct following the merger, negated any incumbency advantage. We have dealt with the other constraints on STS's conduct following the merger elsewhere in this report. Further, whilst we consider that there are factors that mitigate STS's incumbency advantage as set out in this paragraph, there is clear evidence of incumbency advantage in the relevant market to date (see paragraphs 6.16 & 6.17).

7. Findings

7.1 For the reasons set out in paragraphs 6.21 to 6.24, we found that the merger may not be expected to result in an SLC in the market for the supply of TMA services on a retainer basis to UK local authorities.