Interactive Brokers Group
Q1 2014 Results - Earnings Call Transcript
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Executives
Thomas Peterffy - Chairman and CEO
Paul Brody - Group CFO
Deborah Liston - Director of Investor Relations, Institutional Sales

Analysts
Chris Allen - Evercore
Chris Harris - Wells Fargo
Rich Repetto - Sandler O'Neill
Mac Sykes - Gabelli & Company
Brian Lawrence – Oakcliff Capital

Operator
Good day everyone and welcome to the Interactive Brokers' First Quarter 2014 Financial Results Conference Call. This call is being recorded. At this time for opening remarks and introductions, I would like to turn the call over to Ms. Deborah Liston, Director of Investor Relations. Please go ahead.

Deborah Liston - Director of Investor Relations

Thank you, operator and welcome everyone. Hopefully, by now you've seen our first quarter earnings release, which is released today after the market close, and which is also available on our website.

The speakers today are Thomas Peterffy, our Chairman and CEO; and Paul Brody, our Group CFO. And they'll start the call with some prepared remarks about the quarter and then we can take Q&A.

Today's call may include forward-looking statements, which represent the company's belief regarding future events and by their nature are not certain and outside of the company's control. Our actual results and financial condition may differ possibly materially from what's indicated in these forward looking statements. We ask that you refer to our disclaimers in our press release. You can also review a description of risk factors contained in our financial reports filed with the SEC.

And now, I'd like to turn the call over to Thomas Peterffy.

Thomas Peterffy - Chairman and CEO

Good afternoon everyone and thank you for joining us to review our first quarter performance. We are off to an exceptionally strong start this year with our Electronic Brokerage business breaking several new records and our Market Making business benefiting from improved market conditions.

We continue to see an increasing number of customers transferring their accounts to IB in the first quarter and we had our highest ever level of customer daily average revenue trades or DARTs.

This surge in trading volume can be attributed to a combination of factors including more customer accounts, higher market volatility, and higher industry trading volumes overall, but we benefit especially because our customer base is comprised of sophisticated experienced traders and investors that take advantage of volatility spikes to enter or exit positions.

On the final day of the quarter, a highly publicized book Flash Boys was released. This has reignited the debate over high frequency trading and its effect an overall fairness of the market. It has also intensified ongoing inquiries and prompted new investigations of the HFT industry by various regulators and law enforcement agencies that are concerned with potentially illegal front running and insider trading.

I want to be very clear on this. This is going to be a positive and may even be a very big positive for us. First, we have always been strong and outspoken advocate for fair and orderly market and believe that such a scrutiny at the end will be beneficial to our customers and will ensure a more level playing field.

I have spoken several times publicly about my views on market structure and you can find these speeches on our website about IB comment letters and papers.

Second, I have been telling everybody who is willing to listen that the evolution of electronic markets over the past 15 years has been extremely beneficial to especially smaller traders and investors in reducing their transaction costs, but that does not mean that we do not have some problems. Selling order flow is a practice that hurts them and there is a certain amount of front running in the markets. How much and by whom, it is very difficult to tell, but it is easy to fix. I would like to see the SEC mandate that all trading venues must hold liquidity removing orders for end of period between 10 and 200 milliseconds before releasing the order to their matching engine.

HFTs will claim that their supply liquidity will not be affected, but HFT's who front run liquidity removing orders would no longer be able to do that with any certainty.

The book Flash Boys has shed a brighter light on the practice of selling order flow, which many of the eBrokers rely on as a core component of revenue and which is now drawing increased scrutiny from regulators.

Market makers and HFTs compete with each other bidding for long-term agreements to buy the order flow online and other brokers. Whoever pays the most gets the agreement. It is hard to imagine that the internalizer who pays the most for the privilege of executing these orders against himself would go through a lot of trouble to give the customer the best price and potentially suffer a loss as a consequence. We used to pay for option order flow but stopped some years ago with the exception of some very small deals which we continue with in order to maintain a business relationship that I think not may become very useful.

Almost all brokers who do not sell their order flow trade against it themselves. This is especially true for OTC orders that the large investment banks derive a large part of their revenues from. I think that is just as bad as selling the flow to somebody else to trade against it. We had decided early on that this is a conflict we should not have. Therefore, we do not trade against our customers' orders and do not sell our customers' orders. We go through a great length to provide our customers the best possible price of the lowest transaction cost. This will maximize our customers' returns. This is how we have been branding and marketing ourselves as our results indicate this is a winning strategy that we will continue to follow.

Payment for order flow is not a new practice, and it has previously raised the question of whether discount brokers are fulfilling their obligation to achieve best execution for their customers or simply looking to fatten their bottom-line. I am glad to see this issue is spurring discussion and giving us the opportunity to discuss the fact that we do not engage in this practice, because it sacrifices execution quality for customers.

I think that traders and investors, who as a result of this controversy, become aware of the issue are more likely to leave their brokers for one who neither trades against nor sells their orders and that is Interactive Brokers.

As you read our financial filings, you may see mention of payment for order flow as an income item, but it is insignificant to our bottom-line, only about 2% to 3% of brokerage revenues, and it is important to understand that this is not the part of revenue that is at the center of the aforementioned controversy and perhaps should be called by a different name.

This payment comes from two sources. One is payment by exchanges for certain type of orders, the other is payment from ATSs such as IBKR ATS for certain orders that we send there only at the time when we can be sure that we get the best or possibly a hidden and even better price. This gives our customers a chance for a better price and saves us exchange fees, and we share those savings by rebating part of them to our customers.

If you review our Rule 606, order routing reports that we filed with the SEC and it is also located on our website, under about IB, you will find the discussion of our order routing practices and find that we send the vast majority of our customer orders to public transparent exchanges in order to achieve best price execution.

We are well known in the industry for the superior quality of our executions, which are audited by an independent third-party. The results which are published on our website under why IB low cost concluded that in the second half of 2013, IB delivered on the average a $0.23 advantage per 100 shares of stock and a $0.20 advantage for option contract to our customers relative to the industry in terms of price improvements over the national bid/offer.

A well-known broker responded to the recent criticism over payment for order flow by citing that their clients receive price improvement on 90% of bid orders. However, what the statistics conveniently leaves out is by how much customer orders are improved. They could well be counting in this statistical -- in this statistics, orders that execute as little as 100th of $0.01 better than the NBBO and do not include the bid improvement.

Following recent media exposure, we had numerous requests from customers who wanted the option to route directly to IEX, an ATS that is designed to focus on investor protection and performance. We responded quickly to these requests and now customers have the option to route their orders directly to IEX who will use our smart router researches for the best price at the time of the order and fix to immediately execute the order electronically.

At this point, IEX is a dark pool that will forward inter market sweep orders, so that they get to their destinations exactly at the same time. We made IEX available, but believe that our customers remain to be better served by our smart router, which now includes IEX also.

Now before I get into the segment details, I'd like to give you an overall picture of our first quarter results before any currency or tax effects. For the quarter, we reported pre-tax income of $218 million. Excluding currency effects, this was $197 million composed of $134 million of Brokerage, $67 million in Market Making and a loss of $4 million of Corporate. The total per share income of the currency effect is a positive $0.03 for the quarter; therefore if we back this out of our reported EPS of $0.34 for the quarter, our normalized EPS is $0.31.

I'll briefly explain the currency effect that is excluded from these normalized results. As you know, we keep our total equity of $5.2 billion in our self defined basket of 16 currencies we call the GLOBAL in order to minimize the currency risk that we would otherwise be exposed to as an international and diversified firm raising products in 25 different countries.

In the first quarter, the volume of the GLOBAL increased by 0.45% relative to the U.S. dollar, which resulted in an increase in our comprehensive earnings of about $24 million. Of this gain, $21 million is reflected in trading gains and $3 million is reported below the line in other comprehensive income or OCI.

Now I would like to review the performance of our Brokerage segment. This was a breakout quarter for Brokerage. As I mentioned, we broke a number of records this quarter and this segment now accounts for 68% of our profit ex-currency effect. First, we have the highest number of quarterly account additions in Q1 of 12,500, which compares very favorably to the average quarterly account adds in 2013 of 7,400. We finished the quarter with 252,000 accounts which represents a 16% year-over-year increase or 21% annualized. I am optimistic that we can sustain this rate of growth for several reasons. First, over 60% of new accounts are coming from outside the U.S. in countries where we have only scratched the surface in terms of market penetration; and second, nearly one quarter of new accounts this year came from client referrals. This is a testament to the value of our platform and a powerful trend that I expect will multiply as our customer base continues to expand.

This quarter we also posted record DARTs for 582,000 which was 25% higher than the prior year quarter and drove a 14% year-over-year increase in commissions. Thanks to our active customer base we continued to be the largest U.S. electronic broker by a number of revenue trades. Our profit margin of 60% is also a new record, due to our low fixed cost structure we are able to leverage our automated technology to realize meaningful economies of scale and spread our operations costs across more trades.

Our total customer equity is now approaching $50 billion and 38% annual increase, while the average equity per account has increased 19% to 195,000. Institutional accounts including hedge funds, independent advisors, prop trading firms and introducing brokers are growing faster than individual accounts, driving this increase.

Margin balances have reached a new high of $14.4 billion as customers continue to take advantage of our industrial margin lending rates, which currently range from our actual 1% to 1.58% depending on the size of the loan. And margin as a percent of customer equity has stayed pretty consistent, up around 29%.

In addition to posting record results, we are pleased to be recognized for the third year in a row by Barron’s as the overall number one online broker and for taking the top spot in several “best for” categories including best for frequent traders, for international traders and for option traders.

We also achieved the top ranking for trading experience and technology, as well as our portfolio analysis and reports. This is an important distinction that contributes to our growing awareness around professional traders.

This quarter we launched the latest phase of our traders’ marketplace, which brings together individual fund managers, brokers, advisors and most recently administrators to provide the platform for them to connect and do business with each other. In the next quarter we will be integrating this with our existing IB marketplace, which thinks together a variety of third-party vendors and IB customers.

We would also be activating the next phase, which is to allow individual customers to search for financial advisors on our platform. Our goal with this initiative is to facilitate the growth for our customer base and foster relationships amongst them.

We also just launched our Mutual Fund Replicator Tool. Millions of investors own mutual funds and many are not aware of the fact that many of these funds charge 1% to 2% management fee on the value of the fund. This replicator tool allows our customers and especially financial advisors to identify an ETF or a combination of two ETFs that are highly correlated to a particular mutual fund. We show historical returns, after fees, side by side with the mutual funds and the potential saving by switching the mutual fund position for the ETF.

We further upgraded our probability and auction strategy labs and added Volatility Lab. We are in the process of introducing our option exercise calculator, where we notify customers of upcoming dividends and tell them if exercising the option prior to the ex-dividend date would likely result in a better economic outcome.

Unlike other brokers, we charge for exercising options, we can do this without a conflict of interest, because we do not charge for option exercise of assignment. As you see all these developments are targeted to improving our customers' returns and we feel very good about them.

Now I will review the performance of our Market Making segment. Market Making pre-tax profit of $88 million, rose substantially compared to a loss of $29 million in the year ago quarter and $6 million in the prior quarter. However, if we back-out the currency effect, we have a clearer picture of our performance.

As I mentioned earlier, this period's trading gains were positively impacted by a translation gain of $21 million. After backing this out, pre-tax Market Making profits totaled $67 million compared to $32 million in the year ago quarter and $37 million in the prior quarter.

As I mentioned, the environment for Market Making improved in the first quarter. Volatility levels are directly correlated with our Market Making trading gains. The average VIX this quarter totaled 14.8%, 4% higher than the prior quarter and 10% higher than the year ago quarter.

In addition the ratio of actual to implied volatility, which impacts our profit captured versus our cost of hedging was 81% this quarter compared to 73% in the prior quarter and 76% in the year ago quarter.

According to data obtained from the exchanges where we do business, exchange trade options volumes increased 5% in the U.S. and 4% globally for the first quarter. By comparison, our firm's total options volume increased by 4% and as a result of our firms market share share fell slightly from 11.7% to 11.6% in the U.S. and remains stable at 9% globally.

This overall picture would obscure the underlying trend, which is the continuing relative shrinkage of our Market Making volume and continuing relative expansion of our Brokerage volume. In the Market Making segment alone our option volume increased by 2% during the first quarter driving our market share down from 5.5% to 5.3% in the U.S. and from 5.1% to 5% globally.

We continue to pay $0.10 quarterly dividend from Market Making capital. This quarter we earned 14% return on equity above our 10% hurdle rate and as such we naturally accumulated capital in this segment.

I will now turn the call over to our CFO, Paul Brody, who will review the details of the financials.

Paul Brody - Group CFO

Thank you, Thomas. Thanks everyone for joining the call. As usual, I'll review the summary results and then we'll get segment highlights and then we will take questions. First quarter results were outstanding in Brokerage and quite strong in Market Making as well. As compared to the year ago quarter, net revenues were driven by rising brokerage commissions and net interest income, but also by trading gains in the Market Making segment even after excluding the currency translation gains on the weaker U.S. dollar.

Our financial statements as a reminder include the GAAP accounting presentation known as comprehensive income. Comprehensive income reports all currency translation gains and losses including those that reflect changes in the U.S. dollar value of the company's non-U.S. subsidiaries known as other comprehensive income or OCI. These are reported in the statement of comprehensive income. But only a few exceptions, the U.S. dollar weakened relative to other currencies during the first quarter of 2014. As a result, the currency basket we called the GLOBAL strengthened against the U.S. dollar by about 0.4%.

OCI is a component of the total GLOBAL effect, adding OCI to net income increased our reported earnings per share by $0.01 for the quarter. Overall operating metrics for the latest quarter were mixed, volumes were up in futures and stocks and down in options versus the year ago quarter. Average overall daily trade volume was up -- was 1.17 million trades per day, up 16% from the first quarter of 2013.

Electronic Brokerage metrics showed solid increases in the number of customer accounts and customer equity as Thomas pointed out. Total and cleared customer DARTs were both up 25% from the year ago quarter and up strong sequentially as well.

Orders from cleared customers who clear and carry their positions and cash with us and contribute more revenue accounted for 91% of total DARTs holding steady with the recent quarters.

Market Making trade volume was down from the prior year quarter, though contract and share volumes were mixed across product types. Other metrics were generally positive at the level of volatility and actual to implied volatility ratio were both up this quarter. Market Making results were also aided by tailwinds from the currency movements as we described.

Net revenues were $355 million for the first quarter, up 64% from the year ago quarter. Trading gains were $128 million for the quarter assisted by currency translation effects. Our trading gains compared to the year ago quarter increased by 571%. Excluding the currency translation trading gains, we have risen 34% from the year ago results.

Commissions and execution fees were $137 million, up 14%. Net interest income was $72 million, up 24% from the first quarter of 2013. And Brokerage produced $66 million of that and Market Making $6 million.

Other income was $19 million, down 4%. Non-interest expenses were $137 million, up 2% from the year ago quarter. Within the non-interest expense category execution and clearing expenses totaled $54 million, down 9% from the year ago quarter, driven by significantly lower Market Making fees.

Compensation expenses were $54 million, a 16% increase from the year ago quarter. At March 31st, our total headcount was 901, an increase of 1% from the year ago quarter and 2% from the year-end. Within the operating segment, we continue to add staff in Brokerage and cut back in Market Making.

As a percent of net revenues, total non-interest expenses dropped to 39% from 62% in the year ago quarter. Out of this number, execution and clearing expense accounted for 15% and compensation expense accounted for 15% as well. Our fixed expenses were 23% of net revenues.

Pre-tax income was $218 million, up 165% from the same quarter last year. For the quarter, Brokerage accounted for 60% and Market Making accounted for 40% of the combined pre-tax income. Ex-currency effect, the contributions were 67% for Brokerage and 33% for Market Making.

For the first quarter, our overall pre-tax profit margin was 61% as compared to 38% in the first quarter of 2013. Brokerage pre-tax profit margin was 60%, up from 57% in the year ago quarter. Market Making pre-tax profit margin was 66%, up from a loss in the year ago quarter. Excluding translation effects, Market Making pre-tax profit margin was 60% in the latest quarter.

Comprehensive diluted earnings per share were $0.35 for the quarter as compared to $0.06 for the first quarter of 2013. On a non-comprehensive basis, which excludes OCI, diluted earnings per share on net income were $0.34 for the quarter as compared to $0.14 for the same period in 2013.

Looking at the balance sheet; as a result of the growth of our Brokerage business and the withdrawal of capital from our Market Making operations through regular and special dividends, Brokerage now accounts for about 73% of our combined balance sheet assets from the two segments.

From the year ago quarter, cash and security segregated for customers rose 23% and secured margin lending to customers rose 29%, while positions in securities held by our Market Maker units were paired back by 26%.

According to our announced policy, regular quarterly dividends will continue to temper the capital employed in the Market Making segment. In the first quarter, our Market Making earnings exceeded the amount needed to fund the dividend. Our balance sheet remains highly liquid with low leverage. We actively manage our excess liquidity and we maintain significant borrowing facilities through securities lending markets and with banks. As a general practice we hold an amount of cash on hand that provides us with a buffer should we need immediately available funds for any reason. At March 31st, we maintained over $3 billion in excess regulatory capital in our broker dealer companies around the world, of which about 60% is in the Brokerage segment.

We continue to carry no long-term debt. Our consolidated equity capital at March 31, 2014 was $5.24 billion, of which approximately $2.5 billion was held in Brokerage, $2.4 billion in Market Making and the remainder in the corporate segment.

The segment operating results are summarized in the earnings release and will be more fully detailed in our quarterly 10-Q report. So I will just touch on the highlights here in this call. Starting with Electronic Brokerage, customer trade volumes were up across products, all product types. Cleared customer options and futures contract volumes were up 30% and 8% respectively and stock share volume was up 127% from the year ago quarter. While much of this increase came from trading in low price stocks, volume increased in other stocks as well. Customer accounts grew by 16% over the total at March 31, 2013 and by 5% in latest quarter.

Total customer DARTs as Thomas mentioned were 582,000, up 25% from the year ago quarter and up 17% sequentially. Our cleared customer DARTs which generate direct revenues for the brokerage business were 527,000 also up 25% in the year ago quarter and 16% sequentially. The average number of DARTs per account on an annualized basis was 539, up 9% from the 2013 period and 12% sequentially.

Commission revenue rose on a product mix that featured larger average trade sizes in futures and stocks with smaller in options. This resulted in overall average cleared commission per DART $4.14 for the quarter, 10% lower than the year ago quarter and 6% sequentially. Note that commissions include exchange fees which can vary widely.

Customer equity grew to $49 billion, up 38% from March 31, 2013 and up 7% sequentially, well outpacing the S&P 500 index which rose 19% over the past year and 1% over the last quarter. The source of this growth continues to be a steady inflow of new and larger accounts and customer deposits, as well as customer profit. Margin debits continue to build steadily with increasing 30% over the year ago quarter.

Customer credit balances also continue to grow progressively increasing 19% over the year ago quarter, though spread compression persists in restraining net interest income. Higher options and futures trade volumes resulted in top-line revenue from commissions and execution fees of $137 million, an increase of 14% from the year ago quarter and 10% sequentially. These revenues are spread mainly across options, futures, stocks and foreign exchange.

Net interest income rose to $66 million, up 23% from the first quarter of 2013, 9% sequentially. Low benchmark interest rates, which continue to compress the spreads earned by our brokerage units, have been offset by steadily higher customer credit balances in each successive period. And our aggressive lending rates have boosted customer margin borrowing.

Our fully paid stock yield enhancement program continues to provide an additional source of interest revenue that is shared with our participating customers. Net interest income as a percentage of net revenues rose slightly to 29%.

With the growing customer asset base, we believe we are well positioned to benefit from a rise in interest rates. Based on current balances, we estimate that a general rise in overnight interest rates of 25 basis points would produce an additional $55 million in net interest income annually. Further increases in rate would produce smaller gains, because the interest we pay to our customers is tied to benchmark rates versus narrow spreads.

Execution and clearing fees expenses increased to $37 million for the quarter, up 2% from the year ago quarter, but down 18% sequentially, reflecting a non-recurrence system market data charges recognized in the prior quarter which were largely offset against fee income. Fixed expenses increased to $52 million, up 9% on the year ago quarter.

Pre-tax income from Electronic Brokerage was $134 million for the first quarter, up 21% on the year ago quarter and 176% sequentially, which reflects a non-recurrence of losses on certain Singaporean stocks taken in the fourth quarter.

Turning to Market Making; so Market Making trade volume was down 6% from the prior year quarter though mixed across the product types. Options contract volume and stock share volume were down 17% and 1% respectively while futures contract volume was up 5%.

Trading gains from Market Making for the first quarter of 2014 were $128 million, up 571% on the year ago quarter. Currency translation effect positively impacted the first quarter's reported earnings by $21 million, a substantial swing from the year ago quarter when reported earnings were decreased by $61 million.

Our overall equity as measured in U.S. dollars was increased by the weakening of the U.S. dollar against most other currencies. More specifically we measure the overall gain from our strategy of carrying our equity in proportion to the basket of currencies we call the GLOBAL to be about $24 million for the quarter. Because the $3 million translation gain is reported as other comprehensive income, this leads a gain of $21 million to be included in reported earnings.

To summarize this, if we eliminated all currency effects, pretax income from Market Making for the first quarter of 2014 would be about $67 million versus $32 million for the year ago quarter on the same basis.

Execution and clearing fees expenses decreased to $18 million for the quarter, down 25% on the year ago quarter, driven by lower trading volumes and options. Fixed expenses were $28 million, down 6% from the year ago quarter, primarily due to our devoting fewer software development resources to this segment. We have continued our aggressive expense management as we monitor the performance to the Market Making business.

Pretax income from Market Making was $88 million for the quarter, up 404% from the year ago quarter. Taking into account the currency effects from each period, the year-over-year increase in pretax income from Market Making would be 111%.

Now, I will turn the call back over to the moderator and we will take questions.

Question-and-Answer Session

Operator

Thank you. (Operator Instructions). Our first question comes from Chris Allen of Evercore. Your line is now open.

Chris Allen - Evercore

Good afternoon, guys. I guess if we could start off, Thomas as you mentioned that on the account growth in the Brokerage side, a healthy percentage was coming from countries where you have barely scratched the surface, I was wondering if you could touch on what countries they are, where you see the opportunities going forward from a regional perspective?

Thomas Peterffy - Chairman and CEO

I don't really want to be specific about that other than to say that Asia is growing faster than other places. Reason, I don't want to be very specific as you would understand that it is not so easy to do this work, and if I tell other people, our competitors where they would be most effective to go after customers, they would do that.

Chris Allen - Evercore

No problem. And then on the market structure debate, I guess you could say that's going on now, I mean clearly you are on the side of no payment for order flow. Do you think this issue would be solved by implementing a trade-at rule or do you think the SEC should just come out right and ban payment for order flow?

Thomas Peterffy - Chairman and CEO

I think it would be helpful if they ban payment for order flow, because it makes the landscape extremely complicated, and the fact is it's a huge conflict of interest and nobody can tell me that they can really function with this conflict of interest in the best interest of the customer. I think that's nonsense.

Chris Allen - Evercore

Okay. And then last for me, I mean how do you perceive the competitive dynamic currently within the Market Making business? I mean clearly volatility was a helping hand; I am just wondering how the competitive landscape is shaping up in your view point?

Thomas Peterffy - Chairman and CEO

It appears that as the Market Making gets stabilized in the sense that we have maybe as many entering as people leaving the business. So it's still not something that I would want to go into if I were not in it already.

Chris Allen - Evercore

Okay. I'll get back in queue. Thanks guys.

Operator

Thank you. And our next question comes from the line of Chris Harris of Wells Fargo. Your line is now open.

Chris Harris - Wells Fargo

Thanks. Thomas, thanks for sharing all your thoughts about Flash Boys and everything that's been happening, I did have a question on that. So, I think it does seem pretty obvious how you guys potentially benefit on the brokerage side, but one thing I am wondering is how your Market Making business could potentially be impacted by any HFT associated regulation? I mean it sounds like you're not too worried about that. Just wondering if you could expand upon why that might not be negatively impacted?

Thomas Peterffy - Chairman and CEO

If you've been following our earnings calls for some time, then you know that we consider that HFTs are a negative on our operations because you see we have to maintain continuous markets and so many instruments that no matter how fast we get, people who target just a few instruments can always act faster than we can. So as a result, whenever we trade against HFTs, we tend to be under the wrong end of the trade. And so, I think generally people who make markets are not in favor of HFTs, and we would like them to join us and make markets instead of picking us off.

Chris Harris - Wells Fargo

So, if there were speed advantages that were kind of done away with in the markets that you're in similar to what IEX is trying to do in the equity market, would that be a good thing for you guys in the Market Making business or how should we think about it?

Thomas Peterffy - Chairman and CEO

On balance, it would be good.

Chris Harris - Wells Fargo

Sorry?

Thomas Peterffy - Chairman and CEO

On balance it would be good I believe.

Chris Harris - Wells Fargo

Good, okay. Any idea, the number or the size of kind of these predatory HFT activities, I mean I know it's really hard to quantify it, but I mean you guys are kind of front and center in there in the markets, so I think you have much better visibility than perhaps we would.

Thomas Peterffy - Chairman and CEO

We really don’t know. We can just speculate about this, and we really, really have -- we practically have no idea.

Chris Harris - Wells Fargo

Okay. All right. And then thanks for clarifying by the way on your order flow revenue and other income. I assume is that revenue that basically is generated from maker taker that the exchanges offer up?

Thomas Peterffy - Chairman and CEO

The bulk of it is exchange sponsored order, basically rebates of exchange fee.

Chris Harris - Wells Fargo

Okay.

Thomas Peterffy - Chairman and CEO

Although not directly saying that we’ve done our rebate X percent of the exchange fees, but we pay them fees and they send back some of those fees.

Chris Harris - Wells Fargo

No, I understood. It just seems like a really small number for you guys because my understanding was limit orders, general limit orders sent in typically qualified for the maker taker or rebate and being that the revenue numbers so low for you guys, it would suggest that a very small proportion of limit orders being made by your customers?

Thomas Peterffy - Chairman and CEO

The proportion of the limit orders; to tell you frankly, I’m sorry, I don’t want to say the wrong thing, and somewhere here, I don’t clearly see the mechanism.

Chris Harris - Wells Fargo

Okay. All right. Well, that's all I had. Thanks a lot guys.

Thomas Peterffy - Chairman and CEO

Thank you.

Operator

Thank you. And our next question comes from Rich Repetto of Sandler O'Neill. Your line is now open.

Rich Repetto - Sandler O'Neill

Good evening Thomas. Good evening Paul.

Thomas Peterffy - Chairman and CEO

Good evening Rich.

Rich Repetto - Sandler O'Neill

I guess Thomas, you made one recommendation on how to improve the market structure with the, I guess the holding period, so 10 to 200 milliseconds. Would you be a supporter of just removing maker taker? And could you explain why you would be for or against it, just removing it completely?

Thomas Peterffy - Chairman and CEO

You see that when we started Box, -- I came up with the maker taker idea. And then it's taken on a life of its own, and now it's become a sort of a monster. If you look at it theoretically, this is basically just equal to rating the penny which is the minimum price fluctuation because if the maker charge a fee, then that's like bidding higher and offering lower; if he pays a fee, then it's like him offering higher and bidding lower.

So as you know, there are some exchanges on both sides of this equation. And I understand that there are people who are making markets they get paid and then they immediately turnaround and do the trade on another exchange where they also get paid and all they get out of it is collecting the payment. And I think it just basically paints the tape and that it's not real volume. I would generally be in favor of a simplified structure because all these payments where order flow and maker taker, it's just clouds up the picture and it gives more opportunities for brokers to really not tell their customers what it is that they are doing with their orders.

Rich Repetto - Sandler O'Neill

Got it, got it. And I would assume given all the automation the years you have been in the market, you co-locate and take proprietary feeds as well I would assume.

Thomas Peterffy - Chairman and CEO

We certainly do, otherwise we would be toast.

Rich Repetto - Sandler O'Neill

Got it. And I guess moving on a little bit away from the market structure, but on the eBroker you mentioned that the channel that I believe you said hedge funds and institutions continue to be the biggest sort of fastest growing area. Could you just refresh how you are penetrating and why that is that if I have the right segment that's building the fastest, growing the fastest?

Thomas Peterffy - Chairman and CEO

You see, to be very precise here, the fastest growing area is introducing brokers and they are two types. There are the introducing brokers, who basically has an omnibus account with us and so they collect all their customer order flow and they execute that in their name. And then there is disclosed introducing, fully disclosed introducing broker who actually puts these clients in direct communication with us. And so to us they feel like individual clients, but since they come through an introducing broker, we do not count them as individual clients, even though they basically had a very similar profile than our individual clients.

So, they are the fastest growing customer segment and our individual customers are the slowest growing customer segment. And in between we have financial advisors and then trading, proprietary trading shops and hedge funds. And they are sort of in between these two groups.

Rich Repetto - Sandler O'Neill

Got it, very helpful. And I guess the very last question; I'll flip back a little bit on market structure. And Thomas my understanding was the payment for order flow, at least on an exchange level on options, it's aggregated by the exchange, but it comes from the market makers in a particular, I guess option, I guess. And is that what you are realizing or the answer to your other question sort of made it that you are actually reporting or realizing the rebate from the maker taker model on limit orders, is it both or…?

Thomas Peterffy - Chairman and CEO

That's some of the exchange and they are different, but so the CBOE for example is I think, it may still be the biggest exchange. That for example, assess market makers and then they give the specialist or lead market maker a bucket of money and he can then give it to brokers or according to his whatever he likes to do, however he decides which broker gets how much. And so that is probably the primary, because when we are specialists and we get this bucket of money as market makers, we give it all to Interactive Brokers after all, who else would we give it to?.

Rich Repetto - Sandler O'Neill

And that's -- but it's officially coming from the exchange?

Thomas Peterffy - Chairman and CEO

That's correct.

Rich Repetto - Sandler O'Neill

Got it, got it. Congrats on a solid quarter on both the Broker and the Market Maker, thanks.

Thomas Peterffy - Chairman and CEO

Thank you. Thank you very much.

Operator

Thank you. And our next question comes from Mac Sykes of Gabelli & Company. Your line is now open.

Mac Sykes - Gabelli & Company

Gentlemen, and Thomas congratulations. I feel like you have been finally vindicated about your position on the market structure and the negative aspects of HFTs. So…

Thomas Peterffy - Chairman and CEO

Thank you. Thank you.

Mac Sykes - Gabelli & Company

I guess it only took just a small red book, just to extrapolate on your comments, how would you handicap the timeframe for seeing material market perform changes or would you expect this to happen over a couple of years, could it be sooner, I mean would they go after all the items that you discussed tonight or would you expect some kind of staggered approach?

Thomas Peterffy - Chairman and CEO

I will tell you frankly, I don't know, I'm not as close to the regulators as I used to be. I mean they used to ask me for advice, but they don't ask me anymore. So, I have no idea. And even when they did, they didn't do what I advised.

Mac Sykes - Gabelli & Company

Are you thinking about positioning the firm in terms of marketing or you're reacting to this…

Thomas Peterffy - Chairman and CEO

Yes, I would like to make a big deal out of this and I'm working on various ways, so I could make a big deal out of it and take advantage of this mini scandal.

Mac Sykes - Gabelli & Company

A lot of the client -- you referred that your client is being sophisticated. But would you think that some of the clients at eBrokers that have payment for order flow, do you think they are waking up in the last month and thinking about their trade, execution and rates and about this conflict of interest or if that's going drive any change I guess in vendor?

Thomas Peterffy - Chairman and CEO

What I hear is that people are upset and they are thinking about it, but they don't really understand. So, that's the problem. Some of them understand it and those who understand it are even more likely to come to Interactive Brokers than they before. So, that's a good thing because I think we are probably the only broker that I can think of that neither trades against the order flow or sells it, I mean I include all the brokers not only the eBrokers.

Mac Sykes - Gabelli & Company

Okay. And just my last comment, the Brokerage capital continues to build nicely, is there a point where you would think that it could get overcapitalized or you're just still in sort of growth mode there?

Thomas Peterffy - Chairman and CEO

I hope it gets over capitalized. I hope that, I keep reading that bulge bracket firms will have to cut down on certain businesses and I keep hoping that it really happens and that we can pick up some that business.

Mac Sykes - Gabelli & Company

Okay. Thank you very much.

Thomas Peterffy - Chairman and CEO

Thank you.

Operator

Thank you. And our next question comes from the line of Bryan Lawrence of Oakcliff Capital. Your line is now open.

Brian Lawrence – Oakcliff Capital

Yes. Thanks for taking my question. I wonder if you could give some color on the growth in stock trading volume in the Brokerage business, which showed kind of a triple-digit gain for the quarter, a sizable selling gain last year?

Thomas Peterffy - Chairman and CEO

It's a very surprising high gain and it comes from people who are, I mean the bulk of that growth comes from people who are trading low price stocks because we have an extremely low commission on low price stocks in the sense that we limit the commission as a percentage of the dollar value of the trade.

Brian Lawrence – Oakcliff Capital

Got it. Thank you.

Operator

Thank you. And at this time, I am showing no further questions in the queue. I would like to turn the call back over to Ms. Deborah Liston, Director of Investor Relations for any closing remarks.

Deborah Liston - Director of Investor Relations

Thanks operator. And I just want to thank everyone for participating today. I want to mention that we will be posting a clean version of our transcript on our website tomorrow and also the call is available for replay on our website. Thanks again for your time. And have a good evening.

Operator

Ladies and gentlemen, thank you for your participation on today's conference. This concludes the program. You may now disconnect. Everyone, have a great day.