Interactive Brokers Group (IBKR)
Q3 2016 Results – Earnings Call Transcript

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Executives

Nancy Stuebe - Director, Investor Relations

Thomas Peterffy - Chairman and Chief Executive Officer

Paul Brody - Chief Financial Officer

Analysts

Rich Repetto - Sandler O'Neill

Conor Fitzgerald - Goldman Sachs

Chris Harris - Wells Fargo

Mac Sykes - Gabelli

Rob Koehn - Ivy Lane Capital

Sean Brown – Teton Capital

Doug Mewhirter - SunTrust

Operator

Good day, ladies and gentlemen and welcome to the Interactive Brokers Group Third Quarter Financial Results Conference Call. [Operator Instructions] As a reminder, this conference call is being recorded. I would now like to turn the conference over to Nancy Stuebe, Director of Investor Relations. Please begin.

Nancy Stuebe

Thank you, operator and welcome everyone to our third quarter earnings call. Our earnings were released today after the market closed and are also available on our website. Our speakers today are Thomas Peterffy, our Chairman and CEO and Paul Brody, our Group CFO. They will start the call with some prepared remarks about the quarter and then we will take your questions.

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

I would now like to turn the call over to Thomas Peterffy.

Thomas Peterffy

Hello, everybody. Our pre-tax profits for the quarter were $183 million. This is composed of $162 million from brokerage, which in turn includes $3 million bad debt write-down and $3 million reserves for U.S. and foreign regulatory fines. The $183 million also includes $7 million for market making and $14 million from corporate, mostly favorable currency impact.

This summer, specifically July and August, were dismally slow months. Intraday volatility was practically zero. We saw the market open and find its level for the day within the first few minutes of trading and then it would just sit there until the close. Looking at my screen, I use Interactive Brokers Mosaic, I often felt that I must have lost connection. But no, the market had just stopped moving.

Given that, I was pleasantly surprised to see that we were still able to generate an average daily commission income above $2 million in those two extremely slow months. A year or two ago, this number would have been much smaller than account growth over the past few years would have indicated. In other words, what we find is that our newer customers, while they trade less often than our traditional customers, their business is more steady and not dependent so much on market activity. They appear to follow our plan instead of reacting to price moves, which is what our more traditional trading-oriented customer base does.

This, of course, has nothing to do with market making. The market making business had a very hard time covering expenses for the quarter. As I indicated in our last earnings call, we are examining in what form to continue this business or possibly to sell it. We have begun some conversations with potential partners or acquirers. That is all I have to say about this at this time.

Returning to our brokerage business, while commissions were low in July and August for the quarter, our number of accounts were up at an annualized rate of 16% and customer assets rose by an unprecedented annualized rate of 48%. This is due to our ability to attract larger accounts mostly comprised of larger accounts of the four major online brokers and the smaller prime brokerage accounts of the big banks.

In our brokerage business, we service five different types of customers. First, the individual customer, they make up 57% of our accounts, 37% of client equity and generate 51% of commissions. Second, the proprietary trading firms are 3% of accounts, 13% of equity and 17% of commissions. This is the group that was impacted most by the slow trading environment. Their commissions were down 7% from last year even though accounts were up 10% and equity is up 24% in this group.

Individuals and prop traders appreciate our platform the most, because they are the ones who are most sensitive to cost and execution quality as both go directly to their bottom line. There is nobody between Interactive Brokers and the end beneficiary of the account. In addition to the dollar and cent advantage, these accounts also enjoy, free of charge, all the technological advances we are building for hedge funds and money managers, such as research, risk analytics, portfolio analytics and many other utilities.

Our third group of customers are the hedge funds, which represent under 1% of our accounts and 9% of equity and commissions, which are also 9%, and they are our fastest growing commission generating groups. The big banks appear to be consolidating their prime brokerage operations and are happy to see their smaller and less profitable hedge fund clients leave. But this begs the question, if these clients find that they are happier on our more automated and less expensive platform, as they in fact do, will they be followed by their larger peers? We certainly hope so. As I have said many times before, our challenge is overcoming the perception of the end customer level that the larger banks are safer custodians. We believe this to be a false perception as our shareholders' equity is approaching $6 billion. We carry very limited counterparty risk exposure.

Only in cash ForEx, which is 2-day settlement; stock loan which is marked-to-market daily; and some CFDs which are also marked-to-market. We have no swaps or OTC options or other long-term derivatives. So, that the ever more frequently asked question in the industry about too big to fail, the difficulties that European banks seem to be having and the steady accumulation of retained earnings are all helpful to us in this regard.

Advisers with 19% of accounts are our fourth group. They have 26% of equity and 17% of commissions, and they grew relatively slow this past quarter.

We find that they love our platform and technology, but what they care about the most is administrative and compliance help, and not providing that has held our growth back in this segment. This is the reason for our significant new initiative in this quarter, the establishment of our new subsidiary, Greenwich Advisor Compliance Services, to provide services to advisers who are either already on our platform or to entice those who are planning to move their business onto our platform. Our professional team will help both registered advisers of the large firms seeking to go independent and keep all the fees that they charge, and people who are newly entering the advisory business. It is a lucky coincidence that we are launching this service now just as LPL announced their plan to try to sell themselves.

Number five is the introducing brokers that represent 20% of our accounts, 15% of client assets and only 6% of our commissions. You might think that this is not a good business for us, but the fact is quite the opposite, because most of our expenses, other than continuously ongoing software development, are related to customer service. And in this segment, the introducing broker retains those responsibilities so that we do not have that expense.

Here, I would like to say a few words about the news that Scottrade is negotiating with potential buyers and its impact on us. As you know, about a year ago, we announced an informal partnership with Scottrade where they would introduce those of their clients to us who require a more sophisticated platform to trade option spreads. These accounts were brought over with all of their assets onto our platform, but Scottrade continued to service them, in the sense that they retained the helpdesk and customer contact responsibilities. We charge commissions to these accounts at the same rate that Scottrade used to charge them, but rebated to Scottrade the difference between those charges and what we would have charged based on our quantity discounted rate that would apply if all these accounts were one big account. This is our introducing broker model. From our point of view, this informal partnership was the beginning of a larger idea of trying to convince Scottrade that they would increase profitability as a marketing and customer relationship organization and leaving the technology intensive operational aspects of account management - execution, custody, accounting and compliance - to us because we do it for much less than it costs them to do. Scottrade currently has about 2,000 accounts, a bit over 200 million of customer assets with us. We were about to onboard the next batch of customers when their focus suddenly changed. We now understand the reason.

It now looks like this project is probably not going any further. But it was not a waste, because we have several other, although smaller, brokers in the pipeline. As far as the 2,000 accounts are concerned, the new acquirer is likely to move them back to Scottrade. Otherwise, we are excited about the Scottrade news. Just like the LPL news, the fewer brokers, the easier the comparison and the starker the differences between us and them, and the easier it is to compete for the customers. Also, whenever a broker is taken over, we usually get a bunch of accounts from people who were considering coming over to us, but were reluctant to change. Now that they will have to change anyway, they think they may as well come to us and move on to a better and less expensive platform. Therefore, we think that while we will lose the large majority of these 2,000 accounts, we are probably going to pick up a lot more as Scottrade accounts are transferred to the platform of the new buying broker.

Again, providing our highly automated platform at a very low rate to fully disclosed introducing brokers, while those brokers continue their customary relationship management and growing their business, is a very important part of our overall business model. Our accounts in this segment will increase further next month when a mid-sized U.S. bank, with a well-established online brokerage operation, will be joining the ranks of our introducing brokers and begin migrating their customer accounts over to our platform.

Finally a word about our Covestor subsidiary. You may remember that an IB customer may partition his or her account and assign a given amount of money to Covestor to co-invest with a specific money manager or hedge fund on the IB platform. We are now announcing that we are adding Covestor-managed smart beta portfolios to the investment choices. Smart beta portfolios find the sweet spot between passive capitalization-weighted EPS and actively-managed mutual funds. Specifically, Covestor will manage five smart beta portfolios: value, growth, quality, dividend and broad market portfolios, which will be rebalanced quarterly.

The surprise is the management fee. The annual management fee will be 8 basis points. There will be an additional commission charge for the quarterly rebalancing which we estimate at 3 basis points for $100,000 investment. The shares in the portfolio, including fractional shares, will settle into each investor's individual account, and they may be used as collateral for margin loans or for lending in conjunction with our yield enhancement program. We are soft launching this program this week and we will have an official launch on January 1st.

Finally, I would like to inform you that Professor Hans Stoll has asked to be relieved of his Board duties as of today. Hans has been on our Board since April 2008. He was always very supportive and forthcoming with wonderful advice. We will miss him. His seat will be taken by Gary Katz. We have known Gary Katz for several decades, starting at the New York Futures Exchange and then as CEO of the ISE. Gary will be joining our Board as of January 4, 2017.

And now our CFO, Paul Brody, will go over the financials.

Paul Brody

Thank you, Thomas. Welcome everyone to the call. As usual, I will review the summary results and then give segment highlights before we open it up for questions. Overall operating metrics reflected the drop in market volatility and industry volumes. In particular, the August doldrums led to a slide in DARTs to the lowest level since November 2014, but volume rebounded substantially back to more recent levels in September. Average overall daily trade volume for the quarter was 1.26 million trades per day, down 10% from the third quarter of 2015 and down 5% sequentially, as the average VIX level declined 31% and 15%, respectively, over the same time period.

On the positive side, the story of the quarter was strong gains in asset gathering and brokerage, as I will describe more in my comments on that segment's performance. Electronic brokerage metrics showed solid increases in the number of customer accounts and in customer equity, up 15% and 33% respectively. Total and cleared customer DARTs declined 11% and 9%, respectively, from the year ago quarter in the face of low volatility. Note that last year's comparative quarter reflected an extreme run-up in volume from low priced Hong Kong shares and a spike in volume during the August 2015 market turbulence.

Orders from cleared customers who clear and carry their positions and cash with us and contribute more revenue grew slightly this quarter to 93% of total DARTs. Market Making contract and share volumes were similarly down across product types.

Third quarter net revenues declined 4% versus last year, while pre-tax income was down at 9% for a pre-tax margin of 53%. Our brokerage results were boosted somewhat by strong gains in customer accounts and equity, while low volatility and a decline in options volumes continued to impact market making.

Other market factors had the following impact. Market volatility fell, as I mentioned, the average VIX fell 31% year-over-year while actual to implied volatility fell 32%. From a historical perspective, the relatively low VIX dampens trading volume and therefore brokerage revenues, while both measures affect our market making business. With no major events in the quarter creating market volatility, there were fewer opportunities for our market making business in particular.

The U.S. dollar was mixed versus other major currencies. As a result, the currency basket in which we keep our equity, which we call the GLOBAL, rose 0.26% against the dollar for the third quarter. This resulted in a gain of $13 million, which includes the gain of $11 million reported in other income and a gain of $2 million in other comprehensive income, or OCI. We estimate the total impact in earnings per share from the GLOBAL to be a gain of $0.022 for the quarter, with $0.018 reported as other income and $0.004 as OCI.

Finally, medium-term interest rates rose a bit during the quarter as the Federal Reserve appears a bit closer to raising rates. As a result, mark-to-market losses on our Treasury portfolio were $15 million. Although we plan to hold these securities to maturity, we must, as brokers, unlike banks, mark them to market quarterly. Net revenues were $345 million for the quarter, down 4% on a reported basis from the year ago quarter. Several factors that fall outside our core operating activities should be considered in comparing the current quarter's revenues to the prior year's.

First, our currency strategy caused a gain of $11 million, versus a loss of $24 million in the year ago quarter. Next, the treasury portfolio marks to market deducted $15 million from our revenues in the current quarter compared to a gain of $5 million in the year ago quarter. And adjusting for these two factors, on a pro forma basis, our total net revenues would be $349 million in the current quarter and $378 million in the year ago quarter or down 8%.

The decrease was driven primarily by lower trading gains in our market making business and lower commissions versus an unusually strong quarter in 2015, partially offset by a higher net interest income in both brokerage and market making.

Trading gains were $38 million for the quarter, down 56% from the year ago quarter. Commissions and execution fees were $144 million, down 14%. Net interest income was $136 million, up 28% from the year ago quarter, and brokerage produced $131 million, with market making $5 million of the net interest income.

Other income which as I described earlier, includes the effects of our currency diversification strategy and Treasury portfolio marks was $27 million, up from a loss of $1 million in the prior year quarter.

Non-interest expenses were $162 million for the quarter, up 3% from the same quarter last year, and the rise reflects specific increases in fixed expense categories, in particular, legal and compliance costs. And generally, we continued to closely manage our expenses. At September 30, 2016, our total headcount stood at 1,194, an increase of 10% of the year end count and up 2% sequentially. We have continued to expand in a few key areas, notably customer service, legal and compliance, and software development, all of which support the growing brokerage business.

Our reported pre-tax income this quarter was $183 million, leading to a 53% pre-tax margin. And excluding the GLOBAL and treasury portfolio market impacts, our pre-tax income would have been $187 million. This compares with third quarter 2015 adjusted pre-tax income of $221 million, net of the same factors. As adjusted, the overall pre-tax margin was 54% versus 58% last year. Brokerage pre-tax profit was a reported 56% as compared to 61% last year. And adjusted for the Treasury portfolio marks, brokerage pre-tax profit was 58% versus 60% in the prior year quarter. Market making pre-tax profit margin was 16% versus 51% last year.

Comprehensive diluted earnings per share were $0.30 for the quarter as compared to $0.23 for the third quarter of 2015. On a non-comprehensive basis, which excludes OCI, diluted earnings per share on net income were also $0.30 for the quarter as compared to $0.35 for the same period in 2015. And excluding all currency impacts, diluted earnings per share were $0.28 for the current quarter versus $0.37 for the year ago quarter on the same basis.

Our balance sheet remains highly liquid with low leverage. We actively manage our excess liquidity and we maintain significant borrowing facilities through the 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 September 30, we maintained over $4.2 billion in excess regulatory capital in our broker dealer companies around the world, of which about 70% is in the brokerage segment.

We continue to carry no long-term debt and our consolidated equity capital at September 30, 2016 was $5.87 billion, of which approximately $3.9 billion was held in brokerage, $1.6 billion in market making and the remainder in the corporate segment.

Now, I will turn to the segment results and begin with electronic brokerage.

This quarter, we saw a decline in stock volume largely driven by a drop in the low-priced stocks trading in Hong Kong from the spike in the prior year quarter. Customer trade volumes were lower across product types. Overall, cleared trades fell 6%. Cleared customer options and futures contracts and stock share volumes fell 18%, 16% and 5% respectively from the year ago quarter. Foreign exchange dollar volume was off 14% from the year ago quarter. And contributing factors were the overall contraction in the retail FX market as well as our policy change which took effect around September 1, limiting customers with less than $10 million in assets from making FX trades using leverage. We adopted this limitation due to a lack of clarity on the regulation of retail FX business in the United States. However, the impact on our overall FX volume was not substantial.

Commission revenue fell 15% on a product mix that featured smaller average trade sizes across options and futures, and slightly higher average trade sizes in stocks. This mix resulted in an overall average cleared commission per DART of $3.91 for the quarter, down 5% from the year ago quarter, but unchanged sequentially. Customer equity grew to $82.7 billion, up 33% from last year and up 12% sequentially. The source of this growth continued to be a strong inflow of new accounts and customer assets.

We continue to attract larger customers along with financial advisers and introducing brokers that manage groups of smaller accounts, all of which results in a blend that affects both average trade size and average account equity. Our average account equity rose 16% year-on-year, and 9% sequentially, to a record high of $224,000. In addition to the larger accounts that Thomas mentioned, part of this growth was fueled by new services we have made available to administrators of employee stock plans, in which we can act as broker first to the administrator's issuer clients and, later, directly to the employee participants. To the extent we are successful, we would expect this client segment to produce more commission revenues with some lag time.

Margin debits rose 15% year-over-year, reaching their highest levels in over a year. Customers' appetite for increased risk, along with expanded prime broker financing, were responsible for this increase.

Customer credit balances continued their steady growth, rising 20% over the year ago quarter. Net interest income rose to $131 million, up 28% from last year. The acceleration in asset gathering we achieved in the third quarter sets the stage for larger revenue contributions from interest sensitive assets going forward. The Federal Reserve's increase in the Fed Funds target rate last December, together with increased customer balances, has generated more net interest income on cash balances. And our stock yield enhancement program, where we share revenues from lending out fully paid securities with our customers, continues to provide an additional source of interest revenue on securities assets. In addition, we continue to improve our securities lending utilization to capture more revenue from lending hard-to-borrow stocks.

With the growing customer asset base, we continue to believe we are well positioned to prudently maximize our net interest income given the opportunities presented by the market. Based on current balances, we estimate that a general rise in overnight interest rates of another 25 basis points would produce an additional $52 million in net interest income annually. Further increases in rates would have a smaller impact, because the interest we pay to customers is pegged to the benchmark rates less a narrow spread.

Fixed expenses in brokerage were $77 million, up 5% sequentially and 20% over the year ago quarter. Primary components of this increase were higher compensation costs related to software development and higher regulatory costs, which includes legal services and regulatory settlements. As we have stated before, we expect the regulatory burden to continue growing, but we believe our focus on applying technology to compliance and regulation will keep our cost of compliance lower than our competitors.

Customer bad debt expense was $3 million, down 57% from the charges recognized in the third quarter of 2015, which had resulted from the market turbulence in that period. The current reserves are related to exceptional price volatility in several biotech stocks. Our risk committee has used these events to enhance our scenario based risk models to raise margins on stocks that may be faced with similar binary outcome events.

Turning to market making, trade volume declined year-over-year across the product types. Options and futures contract volumes fell 22% and 14% respectively, while share volume was down 36%. As in brokerage, a substantial portion of the drop in stock volume came from low priced stocks trading in Hong Kong, which produced the spike in volume in August 2015. Trading gains from market making for the third quarter were $38 million, down 56% from the year ago quarter, but up 12% from the second quarter. Market volatility measures were similarly lower than the year ago and there were no outstanding market events in the latest quarter that presented us with exceptional profit opportunities.

On the cost side, execution and clearing fees expenses were down 15%, in line with lower trading volumes. And fixed expenses decreased to $19 million, down 21% from the year ago quarter as we continue to pare the cost of running this business.

In the Corporate segment, the earnings reported for Corporate reflect the effects of our currency diversification strategy. Our overall equity as measured in U.S. dollars rose as the U.S. dollar weakened against the euro, Japanese yen and the Australian dollar, among other currencies, and strengthened primarily against the British pound and the Mexican peso. We estimate the overall gain from our strategy of carrying our equity in proportion to the GLOBAL to be about $13 million for the third quarter of 2016. And as I described, because $2 million of the GLOBAL gain is reported as other comprehensive income, this leads to a gain of $11 million to be included in reported earnings. At the end of the second quarter, we made some modest changes to the composition of the GLOBAL, as we reported at that time, and so the third quarter reflects the new basket's proportions.

And now I would like to turn the call back over to the moderator and we will take some questions.

Question-and-Answer Session

Operator

Thank you. [Operator Instructions] And the first question is from Rich Repetto of Sandler O'Neill. Your line is open.

Rich Repetto

Good evening Thomas. Good evening Paul. The brokerage segment showed some, what I would think, is dramatically improved metrics in this quarter. You really got to go back to last year to see when you are growing this fast. And thank you, Thomas for breaking out the different brokerage segments. But I am just trying to understand, it did come quick, which segments are driving this growth, because I thought you said proprietary trading, but anyway I guess the question is as you are seeing margin loans grow 21% quarter-over-quarter, all this account growth and so forth, can you just repeat – yes, where it's coming from?

Thomas Peterffy

Yes. So the margin growth, you have to take with a little bit of salt, because as you know, there were two substantial corporate actions this quarter where people levered up to take advantage of the difference between the market price and the takeover price. As far as the client equity growth, most of it came – I mean they were all very high from – relative to – as I have said, it's 48% annualized for the quarter. And in all segments, it was the lowest in financial advisors relative to a year ago quarter, it was 22% over the year ago. And for introducing broker, it was 62%. And the individuals and the prop trading firms and the hedge funds were in between.

Rich Repetto

Okay.

Thomas Peterffy

I think commission income basically was flat with the year ago, due to a year ago we had an extremely active August. If you remember, the market fell out of bed, and then we had these Chinese problems. And this year, we had a dismally slow August. So this year, we have the same commission income in August as we had last year I mean sorry, the year-to-date commission income is flat from what it was a year ago.

Rich Repetto

Got it, okay. I guess then – that's helpful. The next question Thomas, you mentioned that in Scottrade, 2,000 accounts that they will likely move away if there is a transaction with Scottrade, but you also mentioned a midsized bank, could you tell us whether you anticipate that would go – the size – would it fill the 2,000 account hole?

Thomas Peterffy

It will more than make up for the 2,000 accounts for sure. I am not free to tell you who it is, because they would like to have the opportunity to inform their customers themselves, right. And so this will take place, I expect, within the next 30 days.

Rich Repetto

Got it, okay. And the last question is on the market making, we know it wasn't way profitable, but then if you look at the metrics, this was like – could have been viewed as the most difficult quarter because of the low intraday volatility, so I guess the question is, how did you – did you view the results as, at least in this condition, reasonable? And then you said that when you are exploring sales, maybe last quarter, we thought it was partnerships or sales, it sounded more like an outright sale when you spoke in the prepared remarks and could you clarify that, I guess whether I am reading it right?

Thomas Peterffy

I mean we are open to both alternatives. We would slightly prefer sales because we are being – folks believe – some people believe that our proprietary trading interferes with the pristine nature of our brokerage business. And so we think that if we had nothing to do with prop trading, we will get more brokerage clients. And given the extremely poor performance of market making, it really doesn't – it doesn't look like it's going to improve. So we have certain disadvantages that other folks have been successful in overcoming in market making. And so I think that coming together with one of these firms where – who have succeeded in overcoming the disadvantage we have but do not have all the advantages that we have, maybe putting two things together would be a good idea.

Rich Repetto

Got it. And just one last quick thing, would – it's still the same position, that capital would be transitioned to the broker rather than have any return to the shareholders?

Thomas Peterffy

That is correct. We still – we do not only want to be the best and least expensive broker, we also want to be the safest.

Rich Repetto

Understood. Thank you very much, Thomas.

Thomas Peterffy

Thank you.

Operator

Thank you. The next question is from Conor Fitzgerald of Goldman Sachs. Your line is open.

Conor Fitzgerald

Good afternoon. Thomas, I just want to circle back to some of the comments you made on consolidation and how that could create a market share opportunity for you. I guess the question is would you consider kind of getting maybe more aggressive on the client acquisition side either through advertising or maybe some other upfront investments to try and seize that opportunity if there was consolidation amongst some of your competitors?

Thomas Peterffy

I don't know how to answer that. We would consider anything, but advertising is a – it's always – the return on the advertising dollar is very difficult to measure. And we would love to be more aggressive if we knew how.

Conor Fitzgerald

Got it. And then I just want to circle back on the comment you made, Paul, around expenses kind of continuing to grow with some of the regulatory burden. Can you kind of help us understand maybe the pace and magnitude of that?

Paul Brody

Well, it's – to the extent that there are expenses associated with it – retaining outside legal counsel and representation with regulators and all of that, that's a difficult one, because it's really more up to the regulators than us as to the burden that they are going to impose on all of us. We have, at a measured pace, been increasing legal and compliance staff over the years. So, that's – in the context of our overall staff, it's – from quarter-to-quarter, it's not meaningful number, but it has definitely expanded quite a bit in the last 5 years. So, it's – that's hard to pin a number down on it.

Conor Fitzgerald

Got it. That's helpful. And then one last just one on the expense if I could. I just want to make sure the regulatory fine, did that run through general and administrative and is that why that line item was elevated? And then on the execution and clearing that was just a little higher than I kind of would have thought given the activity level, is there anything to kind of call out there as driving the increase?

Paul Brody

Right. Yes, the regulatory go through general and administrative. And the execution and clearing line didn't change much, but it's as much a reflection of the mix of the products going up and down a little bit. Obviously, certain products have a higher expense ratio, if you will. Commodities cost us more and we mark them up less and so forth. So, what you see is the mix, it didn't – the overall didn't really change all that much.

Conor Fitzgerald

That's helpful. Thank you very much.

Operator

Thank you. The next question is from Chris Harris of Wells Fargo. Your line is open.

Chris Harris

Thanks. A few more questions on the expenses. What kind of expense is going to be involved with the new Greenwich Advisers Compliance that you guys just rolled out, maybe it's not material or maybe you can talk about that a little bit? And then just to verify, the legal and compliance cost you mentioned, are you anticipating those to continue to grow from here? I just want to make sure I heard that correctly.

Thomas Peterffy

So, the Greenwich Compliance group, we are starting with three full timers and two part-timers in the sense that the two part-timers do not only do that type of work, but they also do other work and we hope to expand it from there. So accordingly, the cost could be, I guess maybe $1.5 million. Then the other question was what, again, sorry?

Chris Harris

Yes, I probably shouldn't have said so many questions in one. Just the legal and compliance costs you guys had addressed. I just wondered – I thought I heard you guys had mentioned that they might be growing from here. I just want to make sure that that was accurate?

Thomas Peterffy

Yes. I expect that it will grow, because regulators are becoming more active, not only in the U.S., but also in other jurisdictions around the world and we have subsidiaries in many countries that are now getting regular – more regularly examined by the local regulators and we have to build our systems to – and try to interpret what they really mean when they give us the rules.

Chris Harris

Understood. Thank you.

Operator

Thank you. The next question is from Mac Sykes of Gabelli. Your line is open.

Mac Sykes

Good evening, everyone. I think we have talked about this in the past, but market making, I believe provides some synergies to brokerage. So, I was wondering if you could just shed some light on, if you did sell that asset, what would that do in terms of impacts to the brokerage fixed cost variable?

Thomas Peterffy

Well, it would exceed – I mean increase the cost that is – that will be borne by the brokerage entity, but hard to say by how much. We have done some studies. And would you recall the numbers, Paul?

Paul Brody

Not with enough specificity to give them on this call. I think we have talked about this briefly in the last call and said that these are numbers that can easily be absorbed by brokerage. It's – the analysis is somewhat complex in terms of piecing apart certain technological setups, but we have done a certain amount of work there and I can't tell you exactly how much extra burden that would be to brokerage alone.

Mac Sykes

And just the on-boarding for this new client, is that going to be over a couple of months or do we – should we look for the metrics to change kind of in a lump fashion?

Paul Brody

That's probably over a couple of months.

Mac Sykes

And then my last question is we have obviously seen some evidence of your interest in the elections in November, Thomas. Should the White House remain in Democratic hands, could you go over some of the puts and takes for your business just maybe around regulation, market reforms, corporate taxes, international operations, capital, just like to hear your thoughts on the outlook?

Thomas Peterffy

Look, I would like to make 100% sure that everybody understands that my political activities have absolutely nothing to do with the company. And as to how the impact of the elections, what they would be on the company and on the industry, I don't know any more about it than you do. We all expect that under a Democratic President, regulations will be – regulators will be more active than under the Republican one. That's all I can say about it.

Mac Sykes

Okay, thank you for taking my questions.

Operator

Thank you. The next question is from Rob Koehn of Ivy Lane Capital. Your line is open.

Rob Koehn

Hey, thanks for taking my call. So, first a couple of mathematical cleanup items. Paul, just to make sure I have the numbers right, you said the $15 million mark-to-market loss on the Treasury portfolio that's held on maturity. You would add that back to both the net revenue and the pre-tax income lines of the electronic brokerage segment, correct?

Paul Brody

That's right.

Rob Koehn

So, the $288 million of net revenue and the $162 million of pre-tax becomes $303 million and $177 million.

Paul Brody

That's right, yes.

Rob Koehn

Okay. And so that's how the margin goes from 56% to 58% on an apples-to-apples basis?

Paul Brody

That's exactly right, yes.

Rob Koehn

Okay. And then you also said – and I couldn't understand at the beginning of the call, but there was – you said there was like a $3 million – was it a client loss or something and a $3 million of regulatory fine?

Thomas Peterffy

Yes, I said that.

Rob Koehn

Okay. And so would either of those or both of those be reallocated to the brokerage segment if I was just looking at the segment portfolio?

Thomas Peterffy

Yes, they were both allocated to the brokerage segment.

Rob Koehn

Both to brokerage okay. And so those would both be in – well, I guess, the loss would be – would hit net revenues?

Thomas Peterffy

Yes.

Rob Koehn

And the fine would be in non-interest expense, it would be non-interest expenses?

Thomas Peterffy

Right.

Rob Koehn

Okay. So if I were to...?

Thomas Peterffy

I am not 100% sure of the loss. Paul, do you know, the loss comes out of revenues?

Paul Brody

The customer bad debt loss comes on the expense side.

Rob Koehn

Okay. So they both would come on the expense side.

Paul Brody

Yes. We list customer bad debt as an expense line item.

Rob Koehn

Got it, okay. So the $6 million – so that would be $6 million in total there. So excluding those two items, I guess on a pro forma basis, it would be like $183 million would be sort of an adjusted pretax?

Paul Brody

You mean after – with the mark to market also backed out on the Treasuries?

Rob Koehn

Yes. Just taking the one-time or...?

Paul Brody

Like take everything out, yes.

Rob Koehn

Yes. Just to get a sense, okay.

Paul Brody

Your method is correct.

Rob Koehn

Okay, great. Now – and just to clarify, it was breaking up on my end a little bit, but the 25 basis points, if Fed funds rises 25 bps, that's an extra how much of net interest income?

Paul Brody

Our estimate is $52 million annualized. It's annualized.

Rob Koehn

$52 million, okay. Annualized, okay. And then I guess a couple of questions Thomas, for you, why not – with the market maker, I guess it's just a question of price on a sale, but in the past over the years, you have talked about how maybe there is some optionality there and certainly, you have got some things going on with the exchanges and perhaps, Citadel and some of these other guys, why not consider spinning that off or is it just too small to think about spinning off to shareholders?

Thomas Peterffy

Why would it be easier to run it? It wouldn't be any easier, it would be more difficult.

Rob Koehn

Right. But it would just be – that way the option value of it, theoretically can stay with the existing shareholders, right, I mean if it were to come back to life?

Thomas Peterffy

I don't think – I think there are major changes that have taken place in the market in the last several years. And basically, we have – we were left behind with our pricing, our pricing of stocks. Our pricing is terrific on the options, but we are not as good at pricing stocks as other folks are. And so if we could bring somebody else who is good at stock pricing, somebody else whose stock prices together with our option prices that would be a big winner. But our stock pricing is no good anymore.

Rob Koehn

Okay. Well, fair enough. Okay. And then on the – well, a quick question. So what percentage of cash would you say your brokerage customers hold, I mean I can look at client customer credits and I know some of that are credits resulting from short balances or margin balances?

Thomas Peterffy

Our customers hold $40 billion – $42 billion of cash.

Rob Koehn

Okay. So getting to the customer equity per account metric, so I guess looking at – in Q3, your average customer equity per account was up 8%, 8.1% on my math, which was double the S&P 500, while holding whatever, more than half of their balances in cash, so I mean is that – I know you have talked about it a little bit, but to what extent are these...?

Thomas Peterffy

You can’t look at it so simply. That’s – the amount of cash they hold, but there are other accounts who are borrowing a lot of money, as you know...

Rob Koehn

That was my question, so there is – that’s why I was asking on...?

Thomas Peterffy

And there are also folks who are short stocks and get cash in their accounts. So it’s a composite, not – you can’t look at it so inside...

Rob Koehn

That was the first part of my question. So I guess what I was trying to get to is, are there some really larger accounts that are coming in, so like maybe you can talk – or hedge funds, they dual prime or prime with three or four different prime brokers bringing new – some relatively big accounts that might skew these numbers higher?

Thomas Peterffy

Well, we have lost count – we have about 34 accounts with over $100 million.

<u>Rob Koehn</u>

Okay. And that 34, total accounts or 34 hedge fund accounts?

<u>Thomas Peterffy</u>

34 total accounts.

<u>Rob Koehn</u>

Okay. And how many of those would be hedge funds you would say?

<u>Thomas Peterffy</u>

I wouldn't know.

<u>Rob Koehn</u>

Okay. And so is that a trend that is playing – I mean I have heard anecdotally that there are some funds out there that might be $1 billion fund, but might prime to three different places, but because of your lower costs might move some chunk of those assets to you that are more active funds, is that...?

<u>Thomas Peterffy</u>

Yes. Several hedge fund clients that – who have large amounts of money under management and we are their third or fourth prime broker, they keep a relatively little money with us and keep huge amounts elsewhere because they think that they are too big to fail.

<u>Rob Koehn</u>

Right.

<u>Thomas Peterffy</u>

Yes. Too big to be fail.

<u>Rob Koehn</u>

It seems like that's dipping our toe in the water, it might be a good opportunity, okay. And I guess last on my list here, you mentioned Scottrade is only 2,000 accounts and I guess a minimal amount of revenue, but those accounts are custodied with you, correct, and these underlying clients are using the IB platform right now, right?

Thomas Peterffy

Sorry, let's – give me the beginning number...

Rob Koehn

So I said these accounts are custodied in Interactive Brokers, right and they are using Mosaic or...?

Thomas Peterffy

Right. Yes, of course.

Rob Koehn

So it's not like a buyer can just snap its fingers and say you guys are all moving over to us, I mean the underlying customer still would have to make a decision to ACAT their assets elsewhere?

Thomas Peterffy

Sure. But I mean they have the contact and we are not going to do anything about that to – we are not going to do anything to hold them, because we think that they are fairly Scottrade's customer, fair and square. If they want to stay with us for some reason, they are welcome to. But we are not going to make any effort to do that because we want future customers to understand that when they bring their accounts onto our platform, we are not going to take that away from them.

Rob Koehn

Right. And I think that's – I think being a good – I think that's very smart. But I just want to understand you clarified it, they would actually have to fill out a form to ACAT their assets to whoever this other broker might be?

Thomas Peterffy

Yes.

Rob Koehn

Okay. And how many of these clients do you think realize that IB's pricing is – that they are paying a higher price than they would be as a direct customer?

Thomas Peterffy

I would have no way of knowing it. And as a matter of fact, no I have nothing to assume that they are paying the higher price. You see, what is happening with these introducing brokers, it is really hard for me to make people understand this, so when you are an Interactive Brokers client, depending upon the amount of volume you do, your commission rates ratchet down, right. So if you do – I don't know, maybe a very large number of shares, you only – on the last shares, you only take – pay $0.10 per 100 shares, so it's practically nothing. But we are charging the client, in this case, in Scottrade's case, the same amount as Scottrade would charge them. And then we rebate to Scottrade the difference of the discounted price that we would charge this account if all the Scottrade accounts were one account, right? So in other words, introducing brokers can go out and market their services and charge the same amount that we would charge those customers, individual customers, and retain the difference between the discounted price that we would charge if all the customers belong to one account, versus what our list price is for small accounts. So, it really makes a lot of economic sense to hang out the shingle as an introducing broker that uses our platform. Anybody else?

Operator

And we have another question from Sean Brown of Teton Capital. Sean, your line is open.

Sean Brown

Yes, hi, guys. Just first, real quick housekeeping question on these gain and losses, mark-to-market gain and losses, on the Treasury securities that keep happening and kind of polluting, so to speak, to income statement every quarter. If I look at like E*TRADE, in their 10-K, it says they are treated as available-for-sale securities and all of the gains and losses are unrealized and reflected within OCI. Why would we not be treating it the same as E*TRADE, I guess?

Paul Brody

So from what we understand, many of the other brokers that are aligned with affiliate banks are reporting as banks under bank GAAP, which does not require them to mark-to-market in each period - which is a broker dealer requirement, it's not a choice. So because we hold them as a broker dealer, we have to mark them to market and show them in our income statement. I can't explain to you why banks aren't held to the same rules, but there are lots of accounting conventions that are different between banks and brokers.

Sean Brown

Got it. Understood. So, basically E*TRADE's bank is – gets consolidated within their financial filings, so it's a different standard. So, I guess in order to reflect kind of our steady state financials or I guess comparable financials to these other brokers, could it be possible to just list the pure amount, like $15 million this quarter, in the press releases going forward somewhere?

Paul Brody

Anything is possible. We – Sean, we take your request. We have to be a little circumspect when talking about which things to report on, because if you report non-GAAP measures, you may end up having to do more disclosure, etcetera. I understand it will be helpful to you, so we will absolutely consider it.

Sean Brown

Got it. Yes, it would be helpful in kind of timely modeling purposes. And then next question is around adviser, I know there has been a large new Department of Labor rule published. I think it goes into effect next April and it's over 1,000 pages. So, I haven't actually read the whole thing for myself, but I think – the gist of it is kind of more strictly defining fiduciary duty and what a fiduciary is for the RIAs, for the advisers. I am wondering if the net impact on Interactive should be positive or negative or no real impact, how do you guys view that?

Thomas Peterffy

I am sorry, can you ask me again?

Sean Brown

Yes, sure. There is a DoL – Department of Labor has a huge new rule with, that kind of redefines, I think, the definition of fiduciary duty or investment advisers.

Thomas Peterffy

Yes.

Sean Brown

And I would think it should help Interactive, because our costs would be much lower for the end customer potentially and we don't pay kickbacks to the advisers, right? So, we don't give...

Thomas Peterffy

That is correct. So, we run a very pristine shop and we don't take anything from customers other than commissions and we tell them exactly what it is and it's much lower than anybody else you would compare us to. So, we think that, especially from the point of view of registered advisers, it is going to be helpful for them to cope with that rule when they bring their accounts over on to our platform.

Sean Brown

Got it. Perfect. Thank you very much.

Thomas Peterffy

Yes. And I am sorry, it seems – it appears that I have misstated the retirement date of Hans Stoll. It is actually the last day of 2016. So, Hans is retiring on December 31, 2016. This is his last board meeting today. If anybody else has questions, we...

Operator

Yes, sir. And we have one last question from Doug Mewhirter of SunTrust. Your line is open.

Doug Mewhirter

Hi, good evening. I just had one quick question. Do you have – did you have any material credit losses or exposure from the British pound flash crash in early October?

Thomas Peterffy

No.

Doug Mewhirter

Okay, thanks that's all my questions.

Thomas Peterffy

Thank you.

Operator

Thank you. And there are no further questions at this time. I will turn the call back over for closing remarks.

Thomas Peterffy

There are no further remarks, right?

Operator

Thank you. Ladies and gentlemen, this concludes today's conference. You may now disconnect at this time. Good day.