Interactive Brokers Group, Inc. (IBKR)
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Executives

Thomas Peterffy – Chairman, Chief Executive Officer and President
Paul J. Brody – Chief Financial Officer, Treasurer, Secretary
Deborah Liston – Director-Investor Relations

Analysts

Chris M. Harris – Wells Fargo Securities LLC
Richard H. Repetto – Sandler O'Neill & Partners LP
Niamh Alexander – Keefe, Bruyette & Woods, Inc.
Macrae Sykes – Gabelli & Company, Inc.
Sean Brown – Teton Capital Partners, L.P.

Operator

Good day, everyone, and welcome to the Interactive Brokers' Third Quarter 2013 Earnings 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

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

Our speakers today are Thomas Peterffy, our Chairman and CEO and Paul Brody, our Group CFO. We'll start the call with some prepared remarks about the quarter and then we'll take questions.

Just to remind everyone, today's call may include forward-looking statements which represent the Company's belief regarding future events, which by the nature are not certain and outside the Company's control. Our actual results and financial condition may differ possibly materially from what's indicated in these forward looking statements. We'd ask you to refer to disclaimers in our press release. And you should 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

Good evening, everyone and thank you joining us to review our third quarter performance. This was another strong quarter for our Brokerage business which continues to grow at an impressive rate relative to our peers, in terms of customer trading activity, number of accounts, customer equity and margin balances.

I will elaborate on these as I get into the segment discussions. But first I would like to provide you with a clean picture of our third quarter results without currency or tax effects.

For the quarter our pretax income excluding currency effects was $150 million. This is composed of $108 million of Brokerage, $41 million in Market Making and $1 million in Corporate. For the nine months period to-date the corresponding numbers are $470 million comprised of $343 million for Electronic Brokerage, $123 million for Market Making and $4 million for Corporate.

The operating environment was not nearly as robust as it was in the second quarter when we saw a pickup in exchange share volumes and record customer DARTs. However despite slightly subdued summer activity levels, our customers were much more active this quarter than the same period last year, with total DARTs of 21% higher year-on-year. This growth rate exceeds that of other large e-brokers. It continues to be the case that our customers are more active even while industry volumes dropped.

As a result, we remained the largest U.S. Electronic broker as measured by total number of revenue trades which averaged 471,000 per day in the third quarter.

In our Market Making segment, lackluster market conditions continued to weigh on our profits. Although our trading gains were strongly amplified due to currency movements as the dollar weakened against our global currency basket.

As you know, we’ve based our equity in GLOBALs, our self defined basket of 16 currencies in an effort to minimize our currency risk over the long run given that we are a GLOBAL company trading products around the world in multiple currencies and reporting our results in U.S. dollars.

While this strategy can create large swings in our results from quarter-to-quarter, we are operating in an uncertain global economic environment and we feel it prudent to diversify our capital base in order to reduce significant exposure to any one currency.

This quarter the value of the GLOBAL as expressed in U.S. dollar grew by 1.5% which boosted our comprehensive earnings by about $76 million or roughly $0.12 per share. I will explain in further detail how this affects profits when I discuss Market Making results.

While the environment for Market Making remains challenging for us and others in our industry, we continue to focus on the long-term and things that we can control: That is continuing to deliver high volume to our brokerage customers in the form of sophisticated technology and trading tools while keeping the trading and financing cost significantly lower than our competitors. These differentiators are driving market leading growth.

So first, I will discuss the results of our Electronic Brokerage segment. Customer accounts have grown to 231,000, a year-on-year increase of 13%. Year-to-date customer growth has averaged 2,300 accounts per month compared to 1,700 accounts per month in 2012. This growing momentum is a testament to the solid reputation we are building and the proliferation of positive feedback from our current customers which attracts referrals, our leading source of new accounts.

Customer equity has reached $41.4 billion, 31% higher than a year ago. While the rise in market values has contributed part of that, as illustrated by the 17% year-on-year increase in the S&P, most of this growth comes from new customers opening accounts or current customers bringing more assets to our platform. Also the size of these accounts is growing as we attract more institutional customers. The average equity per account rose 16% year-over-year to $179,000.

We saw a 7% decrease in DARTs in this period compared to the second quarter, which reflects the industry wide slowdown in volumes although less pronounced, thanks to our active customer base. This slight decline in trading activity compared to the second quarter drove a 12% decrease in our pretax brokerage profits from the previous quarter, but we saw a 34% increase from the year ago quarter. We also delivered a 56% profit margin this quarter, thanks to our extremely low fixed cost structure.

Margin balances have grown to $12.7 billion, a 38% increase over the prior year, primarily driven by our extremely low financing rates, which today range from 0.5% to 1.59% depending upon the size of the loan. Our customer mix continues to shift away from direct individual accounts, which currently comprise less than 60% of our accounts and just slightly more than half of total commissions.

Our fastest growing segment is introducing brokers fully disclosed accounts, which have increased 23% year-over-year followed by prop trading desks and financial advisors, which increased 12% and 11% year-over-year respectively. The surge we've seen with introducing brokers is mostly in Europe and Asia for now, but we expect to gain similar penetration in the U.S. in coming quarters.

We find that we can partner with local brokers that excel at offering personal high touch client service while we can provide robust trading technology, advanced trading tools and broad GLOBAL market access in addition to clearing, custody and reporting and all the other advantages that we provide our direct clients at lower prices.

These local brokers are able to consolidate their clients' trading volumes to take advantage of our lowered price tiers and add a mark up to compensate for the personal services that they provide. We are also making strong headway with independent financial advisors; our focused marketing efforts to this audience and our state of the art tools for allocating block trades across separately managed accounts have been a strong draw.

And an especially attractive feature of our platform for transitioning and establishing registered investment advisors is that we provide advisors with one stop solution for custody, clearing and execution with much of the back office support they normally have to seek out with separate providers and end up paying extra for these services.

With our platform, we offer all these tools for no additional charge, including rebalancing software, model portfolios, billing and customized reporting. And as a technology firm, with a strong focus on programming and development, we can be very nimble in responding to clients' changing needs and rolling out new products. We are also getting ready to roll out a customer relationship management or CRM module that will allow advisors manage their clients from prospect to account application to funded account.

We have been focusing and bolstering our prime brokerage offerings, during the quarter we hired a Vice President of Securities Lending Services to further strengthen our competitive positioning in the Securities Lending market.

Our availability of hard to borrow stocks and our extremely competitive borrow rates have proven very effective to hedge fund clients. This service combined with our superior execution and extremely low commissions and financing rates has drawn many of these firms to our platform.

I should mention that our online capital introduction program has been quite successful; our hedge fund customers can market their funds through Interactive Brokers customers, who are accredited investors and qualified purchasers. In the past year, the number of hedge funds participating in this program has more than doubled and approximately 40% of these funds have received the investments.

Transaction Analytics Group or TAG, a third-party provider of transaction analysis, has confirmed yet again that IB's price execution for stocks and option are significantly better than the industry during the first half of this year. Specifically our price improvement was $0.05 per 100 shares of U.S. stock and $0.21 per contract for U.S. options better than the industry average. This is a key selling point for our active customers many of which have moved to IB solely for our execution quality.

Our commissions are among the lowest in the industry across all products. During the third quarter, our average stock trade contained nearly 1,500 shares, at the commission of $2.31. The average option trade contains 9 contracts at the commission of $6 and there were 3.5 contracts to the average futures trade at a commission of $6.28. Please keep in mind that these numbers include exchange fees and are averaged over 100 exchanges, which have very different fee structures.

Now I'll review the performance in our Market Making segments. Market Making pretax profits fell 3% compared to the year ago quarter but had a strong increase over the previous quarter. Backing out the translation effects paints a clear picture. As I mentioned earlier this quarter the GLOBALs strengthened against the U.S. dollar contributing a gain of $76 million to our comprehensive earnings, approximately $46 million of this is included in trading gains.

If we back out the $46 million pretax profit in Market Making ex-translation would had been $41 million this quarter. This compared to $49 million in pretax profit ex-translation for the year ago quarter and $50 million for the previous quarter. This decline can be attributed to lower volatility levels and weaker exchange traded volumes, which negatively impacts our trading gains.

The VIX averaged 14 in the third quarter compared to 16 in the year ago quarter. The ratio of actual to implied volatility were sharply lower as well, falling from 71% in the year ago quarter to 63% in the current quarter, and 95% in the previous quarter.

As you know this is an important profit driver for our Market Making business, with the higher ratio driving higher trading gains. This is because implied volatility determines the costs of hedging while actual volatility measures the price movement of underlying products over time and is directly related to our trading gains.

Exchange trade option volumes decreased 14% in the U.S. and decreased 11% globally from the second quarter. By comparison, our firm's total option volume decreased 17%. As a result, our firm's market share decreased from 11.8% to 11.7% in the U.S. and from 9.3% to 8.7% globally.

In the Market Making segment alone our option volume decreased by 20% during the third quarter, which drove our market share in that segment from 6.2% to 5.9% in the U.S. and from 5.9% to 5.3% globally. Our market share in this segment has slowly being declining as we reduced our participation in markets that are less profitable for us.

We continue to pay $0.10 quarterly dividend which comes out of the Market Making unit's capital. We seek to earn at least 10% pretax return on capital in order to sustain this dividend otherwise we naturally shrink capital in this business. This quarter we earned 6.8% pretax return on capital and as a result our capital is now $2.4 billion in this segment after dividends. The fate of this business has been a prime focus to investors, but we are continuing to monitor the environment as well as keeping an eye on discussions around regulatory capital requirements for banks and brokers. We are not about to make any hasty decisions at the risk of missing potential opportunities, especially in a business we have been in for four decades.

Our financial condition is solid which gives comfort to our customers and investors. The S&P credit rating on our brokerage units of A minus outlook stable is superior to all major banks except JPMorgan, which is A outlook negative. We have organically grown our equity capital to over $5 billion, over half of which roughly is in excess of our regulatory requirements. We feel it is prudent to maintain a significant liquidity cushion in order to weather rough times or take advantage of opportunities that may present themselves.

We are executing on our vision which is to create a global marketplace for professional traders where investors can shop for hedge funds on our online cap intro site, where wealth advisors can select money managers in our money manager marketplace, and where investors can trade from all over the world, can open account and trade nearly any exchange-traded products in 22 countries and counting.

Customers are not only drawn to our platform for best-in-class technology and industry low cost, but also because they understand the importance of selecting a well-capitalized broker with solid credit rating and sound risk controls for protecting their assets. This leads me to address the recent event that will likely result in a charge to the earnings in the fourth quarter. While we have a solid track record for minimizing customer and firm losses, thanks to our automated risk management controls, we are not completely immune to swift and unusual market movements.

A group of our brokerage customers took a large position in four stocks listed on the Singapore Stock Exchange. And in early October within a very short timeframe, these stocks lost over 90% of their value. The accounts were margined and we were able to liquidate only a small part of the position. The accounts are currently in deficit to the extent of approximately $68 million.

We believe that the customers have substantial assets independent of the companies involved and we are currently organizing our legal team to collect on these debts. We are currently also in the process of modifying our margin lending methodology to limit the chances of similar events happening in the future.

On a different matter, in November we are planning to launch the first phase of our novel options trading suite of interactive tools and educational material. You have never seen anything like it. We are preparing to heavily advertise this initiative both in print and on television.

I will tell the essence of what I have learned about options in my 40 years in the business. And give our customers the tools to take advantage of that knowledge on our platform. I believe that this effort will have a significant impact on the options industry and propel Interactive Brokers to a number one position by far among options brokers.

And now, Paul Brody will tell you about the financials.

Paul J. Brody

Thank you, Thomas. Thanks everyone for joining the call. As usual I will first review the summary results and give segment highlights and then we'll take questions.

Third quarter results showed continuing strength in the brokerage business and slightly lower earnings in the Market Making segment as Thomas said. As compared to the year ago quarter, net revenues this quarter were driven by rising brokerage commissions and net interest income, partially offset by declines in trading gains. Market Making profits though lower were supported by currency translation gains on the weaker U.S. dollar.

As a reminder our financial statements 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. In light of the weakening of the U.S. dollar relative to a number of other currencies adding OCI to net income increased our reported earnings per share by $0.07 for the quarter.

Overall operating metrics for the latest quarter were mixed, volumes were up in futures and stocks and down in option versus the year ago quarter. Average overall daily trade volume was 987,000 trades per day, up 14% from the third quarter of 2012.

Electronic Brokerage metrics shows healthy increases in the number of customer accounts and customer equity. Total include customer DARTs were both up from the year ago quarter, though down from the highly active second quarter, in line with industry options, volume declines.

Orders in cleared customer who clear and carry their positions in cash with us and contribute more revenue accounted for 90% of total DARTs holding fairly steady with the recent quarters.

Market Making trade volume was up, though contract and share volumes were mixed across product types. Other negative metrics such as the decrease in actual to implied volatility ratio were somewhat offset by gains on our currency diversification strategy.

Net revenues were $326 million for the third quarter, up 2% from the year ago quarter. Trading gains were $123 million for the quarter, assisted by currency translation effects while trading gains compared to the year ago quarter decreased by 18%, excluding the translation – trading gains would have dropped 29% from the year ago results.

Commissions and execution fees were $120 million, up 20%. Net interest income was $62 million, up 21% from the third quarter of 2012. Brokerage produced $56 million of that and Market Making, $6 million. Other income was $21 million, up 21%.

Non-interest expenses were $130 million, down 11% from the year ago quarter. Within the non interest expense category, execution and clearing expenses totaled $66 million, down 9% from the year ago quarter driven by significantly lower Market Making fees. Compensation expenses were $44 million, a 23% decrease from the year ago quarter.

At September 30, our total headcount was 878, reflecting a small reduction from the year ago quarter and the prior year headcount. However, within the operating segments, we continue to add staff in Brokerage and cut back in Market Making.

As a percentage of net revenues, total non-interest expenses dropped to 40% from 46% in the year ago quarter and out of this number execution and clearing expense accounted for 17% and compensation expense accounted for 14%. Our fixed expenses were 23% of net revenues.

Pretax income was $196 million, up 14% over the same quarter last year. For the quarter, Brokerage accounted for 55% and Market Making, 45% of the combined pretax income. Ex-currency effect, the contributions were 72% for Brokerage and 28% for Market Making.

For the third quarter, our overall pretax profit margin was 50% as compared to 54% in the third quarter of 2012, and Brokerage pretax profit margin was 56%, up from 48% in the year ago quarter. Market Making pretax profit margin was 67%, up from 59% in the year ago quarter and excluding translation effects, Market Making pretax profit margin was 49% in the latest quarter.

Comprehensive diluted earnings per share were $0.39 for the quarter as compared to $0.30 for the third quarter of 2012. On a non- comprehensive basis which excludes OCI, diluted earnings per share on net income were $0.32 for the quarter as compared to $0.26 for the same period in 2012.

Turning to the balance sheet; as a result of the growth of our Brokerage business and withdrawal of capital from our Market Making operations through regular and special dividends, Brokerage now accounts for about 70% of our balance sheet assets. From the year ago quarter, cash and securities segregated for customers rose 3%, and secured margin lending to customers rose 36%, while positions in securities held by our Market Making units were pared back by 22%.

According to our announced policy, regular quarterly dividends will continue to tamper the capital employed in the Market Making segment. In the third our Market Making earnings exceeded the amount needed to fund that dividend. 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 reasons. At September 30th, 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 September 30th, 2013 was $5.07 billion.

The segment operating results are summarized in the earnings release and will be more fully detailed in our quarter 10-Q report. So I will now just highlight the noteworthy items. Starting with electronic brokerage; customer trade volumes were up across all product types. Cleared customer options and futures contract volumes were up 15% and 21% respectively and stock share volume was up 49% from the year-ago quarter.

Customer accounts grew by 13% over the total of December 30, 2012 and by 3% in the latest quarter. Total customer DARTs were 471,000, up 21% from the year-ago quarter, but down 7% from the active second quarter of 2013. Our cleared customer DARTs which generate direct revenues for the Brokerage business were 426,000, up 15% on the year-ago quarter and down 8% sequentially. The average number of DARTs per account on an annualized basis was 469, up 3% from the 2012 period, down 11% sequentially.

Commission revenue rose on our product mix that featured larger average trade sizes and futures and stocks and smaller in option. This resulted in an overall average cleared commission per DART of $4.32 for the quarter, 2% higher than the year-ago quarter, though down 4% sequentially. Note that conditions include exchange fees which can vary widely.

Customer equity grew to $41.4 billion, up 31% from September 30th 2012 and up 11% sequentially. These changes took place during periods in which the S&P 500 Index rose 17% over the past year and 5% over the last quarter. The source of the growth continues to be a steady inflow of new accounts and customer deposits, as well as customer profits.

In addition, our favorable financing rates had allowed us to attract customer margin borrowings. After falling to lows in the fourth quarter of 2011, margin debits have been building steadily to $12.7 billion, 38% over the quarter end level a year ago.

Customer credit balances, which increased 21% over the year-ago quarter also continue to grow progressively, though spread compression, especially of certain foreign currencies persist in restraining interest income. Higher options and futures trade volume resulted in top line revenue from commissions and execution fees of $129 million, an increase of 20% from the year-ago quarter but down 13% sequentially. These revenues are spread mainly across options, future stock and foreign exchange.

Net interest income rose to $56 million, up 19% from the third quarter of 2012 and down 4% 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 borrowings.

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 revenue grew slightly to 29%.

With the growing customer asset base, we believe we are well positioned to benefit from our rising interest rates, based on current balances we estimate that a general rise in overnight interest rates of 25 basis points would produce an additional $56 million in net interest income annually. Further increases in rates would produce smaller gains because the interest we paid to our customers is pegged to benchmark rates less at narrowed spread.

Execution and clearing fees expenses increased to $37 million for the quarter, up 5% from the year ago quarter but down 9% sequentially and in line with the volume changes. Fixed expenses decreased to $50 million, down 4% on the year ago quarter. Pretax income from Electronic Brokerage was $108 million for the third quarter, up 34% on the year ago quarter, but down 12% sequentially.

Taking a look at Market Making, trade volume was up 8% from the prior year quarter, though mixed across the product types. Options contract volume was down 16% while futures contract volume and stock share volume were up 42% and 35% respectively.

Trading gains from Market Making for the third quarter of 2013 were $123 million, down 18% on the year ago quarter. Currency translation effect positively impacted the third quarter's reported earnings by $46 million, similar effect to the year ago quarter, when reported earnings were increased by $42 million.

Our overall equity as measured in U.S. dollars would increase by the weakening of the U.S. dollar against most other currencies, more specifically we measured the overall gain from our strategy of sharing our equity in proportion to the basket of currencies we call the GLOBAL to be about $76 million for the quarter. As Thomas said because at $30 million translation gain is reported as Other Comprehensive Income this lead to the gain of $46 million to be included in the reported earnings.

To summarize, if we eliminated all currency effects, pretax income from Market Making for the third quarter of 2013 would be about $41 million.

Execution and clearing fees expenses decreased to $19 million for the quarter, down 31% on the year ago quarter, driven by lower trading volumes in options.

Fixed expenses were $24 million, down 33% from the year ago quarter primarily due to lower compensation expense and to our devoting fewer software development resources to this segment. We have continued our aggressive expense management as we monitor the performance of the Market Making business.

Pretax income from Market Making was $88 million to the quarter, down 3% from the year ago quarter. Taking into account the currency effect from each period the year-over-year decrease in pretax income for Market Making would be 15%.

Now I'll turn the call back over to moderator and we will take some questions.

Question-and-Answer Session

Operator

Thank you. (Operator Instructions) And the first question comes from Chris Harris of Wells Fargo Securities. Your line is open.

Chris M. Harris – Wells Fargo Securities LLC

Thanks, good evening guys.

Thomas Peterffy

Hello, Chris.

Chris M. Harris – Wells Fargo Securities LLC

So first question I guess is on the growth of the broker, Thomas, you've talked a little bit about some of the things you guys are doing, to kind of make a bigger push in some of these other customer groups, I'm just wondering some of these other customer groups like the RIAs and the hedge funds it seems to me that perhaps these customers might require a little bit more on the customer service side, and just wondering if that's true or not and if it is as you guys penetrate a little bit deeper, should we expect cost to maybe kind of inflate a little bit?

Thomas Peterffy

Well, you see, what we would rather do is partner with some of these mini primes who would do the hand holding and the so called customer service and so the cost would not show up on our books.

Chris M. Harris – Wells Fargo Securities LLC

I see, is there a big differentiation between the profitability in your various customer groups or are you guys really agnostic to where you're getting the account growth from?

Thomas Peterffy

Well, I will tell you frankly, the individual customers seem to be the most profitable, because they are professional ones. They never need to call us for anything, they've been with us for years, they understand the system, they – we've almost never have to interact with them, and so that's our sweet spot.

Chris M. Harris – Wells Fargo Securities LLC

Yeah, okay, that makes sense, that what I would I guess expect. Okay, then on the trading side, you guys had nice growth, but I think with you guys, it's kind of a special case, because you are having such strong growth in accounts, meanwhile you are also having strong growth in trading. It's sometimes hard for us to differentiate whether the growth in trading is been driven by the accounts or if it's been driven by kind of a cyclical recovery in trading activity. So I wonder if you could share any of your thoughts there. Do you think volumes are still kind of cyclically depressed, are you seeing some improvement and how your customers are behaving, are they kind of engaging more, trading more, anything you can share there would be helpful?

Thomas Peterffy

Yeah, you see, if I could find the number of trades per account then that would be immediately obvious…

Paul J. Brody

Yeah, do you have the average DARTs per account?

Thomas Peterffy

Yes.

Chris M. Harris – Wells Fargo Securities LLC

Yeah, it's up 3% year-on-year. You guys said that in your…

Thomas Peterffy

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So that should answer your questions, right?

Chris M. Harris – Wells Fargo Securities LLC

Yeah, okay. That could be isolated to specific customer groups or what have you, I was just more thinking broadly across the whole franchise, but all right.

Thomas Peterffy

It's prop trading clients are obviously the most – they have the highest volumes per account and followed by hedge funds and the lowest volume per account we get from financial advisors and introducing brokers.

Chris M. Harris – Wells Fargo Securities LLC

Okay. My last question, that is on the charge or the anticipated charge for the fourth quarter. How are you guys going to account for that do you think or you are going to write off all $68 million or this is just going to be some portion of that?

Thomas Peterffy

At this point, it's too early for us to tell how much we can recover how soon, right.

Chris M. Harris – Wells Fargo Securities LLC

Yeah.

Thomas Peterffy

So as we go into the quarter, we will make a decision by the end of the next quarter and we will make a conservative decision. So we will probably write down more than we really think and then hope that we get some of it back.

Chris M. Harris – Wells Fargo Securities LLC

Okay. Because my understanding with how those margin accounts work is that they are really the only collateral that was securing and is the securities that were actually in the account?

Thomas Peterffy

No, I mean people are personally liable for these debts and these are well-known industrialists indeed. So they have large positions, not only in these companies, but others also. So let's see.

Chris M. Harris – Wells Fargo Securities LLC

Okay, got it. Thank you, guys.

Operator

Thank you. The next question is from Rich Repetto of Sandler O'Neill. Your line is open.

Richard H. Repetto – Sandler O'Neill & Partners LP

So my first question would be the $68 million, I am assuming that's pretax and could you also say, when you said a group, how many industrialists or how you refer to them are there?

Thomas Peterffy

Roughly seven individuals involved and of course, yes, the loss is pretax if it ends up a loss here.

Richard H. Repetto – Sandler O'Neill & Partners LP

Okay. So is it –let's just say in the worst case scenario would be tax effected and it'd be much less than even 3% of your brokerage equity, is that sort of the worst case scenario?

Thomas Peterffy

Yeah, that's correct, yes.

Richard H. Repetto – Sandler O'Neill & Partners LP

Okay. And then I am looking at just equity overall for the company, now $5.1 billion and I thought you said, at one point that the Market Maker was 2.4 and you have the Brokerage segment in the earnings release it's 2.4. And while you say surpassed 2.4, could that be – is the brokerage all of the rest of the 2.4 you said at the Market Maker?

Thomas Peterffy

Well we also have some corporate and Paul, this is your area.

Paul J. Brody

Yes, it is. Well it's mostly split between the two segments Rich.

Richard H. Repetto – Sandler O'Neill & Partners LP

Okay. And then the – on the comp you had extremely low comp, could you just - Paul, could you just give the break out of the compensation between Market Making and Brokerage to see whether we got it clearly?

Paul J. Brody

Well, yes, in general terms the headcount is being cut back in the Market Making side and increased in the Brokerage side, so overall there wasn't too much change. In the Market Making side, we tend to accrue according to our performance.

Thomas Peterffy

Yes, but the way you keep these books is that you also have – what you call general administrative overhead, which really has a lot of – most of that is – practically all of that is really compensation.

Paul J. Brody

Well, it's spread and in fact it's…

Thomas Peterffy

And that is because of the development staff that is being shared so they basically allocate their charges to the two segments and so they come across as administrative overhead rather than compensation.

Paul J. Brody

Right, and that's why I said in my remarks, that it's not just a trade effect but also devoting less software development resources ends up in reducing the cost of Market Making segment.

Richard H. Repetto – Sandler O'Neill & Partners LP

Okay. And one last final one, we are approaching, getting closer to year-end and you did a special dividend last year. If you look at capital, I believe – how do you think is that even started to enter into your thoughts as we approach year-end or what do you look at, how does this year…?

Thomas Peterffy

I basically am following what is going on in the banking and brokerage business as far as demand for higher capital is set aside from the various regulators both in Europe and the United States, and I still keep thinking that as a result of that certain lucrative areas will emerge for brokers with who have substantial excess capital like we do.

Richard H. Repetto – Sandler O'Neill & Partners LP

I understood. So you're looking at it as opportunities out there.

Thomas Peterffy

Right.

Richard H. Repetto – Sandler O'Neill & Partners LP

Potentially.

Thomas Peterffy

Right.

Richard H. Repetto – Sandler O'Neill & Partners LP

Okay. Thank you.

Operator

Thank you. The next question is from Niamh Alexander of KBW. Your line is open.

Niamh Alexander – Keefe, Bruyette & Woods, Inc.

Thanks for taking my question. Thomas, I'm going to go back to the potential charge and then thanks for giving us the heads up in here, but help me understand how could this happen with seven customers, was it all overnight? Did you let them kind of run the positions because usually, I mean, your risk controls is one of your strongest characteristics. So I'm trying to get comfortable at, it just won't happen again. And you've got so many customers 70 million almost from just seven. Now I know their extreme stock movements, but can you walk me through what happened and help me understand if it could happen again or what's changed in the sense, so it cannot happen again.

Thomas Peterffy

Right, so these seven customers have – were invested in four specific stocks, trading under Singapore Stock Exchange. The stocks on first Friday of October started to fall precipitously in price and the Exchange closed, suspended trading in them. So while they were trading around $2.70 or so, they fell to the region of around $0.80 and were suspended. And on Monday, the stocks were reopened and they immediately traded in around $0.10 to $0.15. So okay, where we made our error is that these stocks were at a fairly low levels similar to where they are today several months ago. They were running up in price over the last couple of – two or three months, and we had made the error of not noticing that. So suddenly – it’s basically – you know, they're in a way like say Tesla, right? And as they rose, these customers were getting more and more margin and buying more and more of the stock. But we have now put in rules or are in the process of putting in rules that will not allow us to lend margin of the same extent on rapidly rising stocks. So I think that those rules will diminish the chances for something like this to happen again.

Niamh Alexander – Keefe, Bruyette & Woods, Inc.

And what about – I guess you couldn’t have stop them out earlier because it happened on Friday and it opened up lower on Monday…

Thomas Peterffy

No, we ran into liquidation, but they were all for a very short period of time, and we then didn’t actually know if our liquidation was pushing the price or not.

Niamh Alexander – Keefe, Bruyette & Woods, Inc.

Yes, yes, yes. So, it's not like you sat on it for days or anything like that. You liquidated it pretty quickly, but there wasn't much left. These are kind of industrialists and they have other accounts with you, but you can’t cut…

Thomas Peterffy

No, they do not have other accounts with us. They do have other accounts with other brokers and they are known to the exchange. It's a different world. It will take us some time to figure out what is the best way of recovering these monies.

Niamh Alexander – Keefe, Bruyette & Woods, Inc.

So right now the change you made against the kind of when there is a lot of volatility in the stock and a lot of price movement you're going to limit the margin and that's across the board, not just specific to that market?

Thomas Peterffy

That’s correct. This will go across all issues.

Niamh Alexander – Keefe, Bruyette & Woods, Inc.

Okay, okay well that’s helpful. Thank you for expanding on it. And then if I could just to go back to the compensation cost, Paul, if I could. I mean, the 44 was a big drop and I know you kind of said that, look we accrue bonuses part of the unit, but is there a bit of a catch up kind of reverse accrual in here or is this a good run rate to think about as we go forward the quarters, because we're trying to drop the number in the model, but are we going to get a bit surprised if it comes back up next quarter. I'm just wondering if there was a catch up in the third quarter there.

Paul J. Brody

Well, I wouldn't characterize it as catch up, but neither would I say that it's indicative of a run rate going forward. For example, one component of comp expense is the stock incentive plan shares and when someone leaves the company, there is a forfeiture involved there. And that can bring previously recognized expense back to us, right, and depending on the size of each quarter that can have some impact. So it's hard to predict that kind of run rate because it's sort of particular to the actual staff that are staying and going.

Niamh Alexander – Keefe, Bruyette & Woods, Inc.

Okay, so I guess, it will shake out somewhere between where you've been tracking. Then I guess the other thing is, Thomas, if I could go back to you. You had mentioned earlier, you brought on your strategy – you were expanding in a strategy to get more business from the institution brokers in the U.S. What are you going to do differently there to attract the business and then just other thing you had mentioned, you hired a VP of Securities Lending. What do you expect them to do differently than what you've been doing before?

Thomas Peterffy

I think Paul, should answer the second question.

Paul J. Brody

Sure. You want me to do that first.

Thomas Peterffy

Please, please.

Paul J. Brody

Absolutely well, we are putting a whole new focus on improving our capabilities to support customers who want a short stock and we have a multi pronged approach there starting with increasing the inventory we have available to us, and that means reaching out to counter parties on the street and agent lenders and the large banks and so forth. And then extending the other way to bring better tools to customers to allow them to analyze what we have available and when it becomes available and we have a real time system, so that when they indicate an interest to sell something sure that it's not yet available, we immediately go to the street and we try to find it and we feed that information back to them. So where the process is developing more and more of these tools that will just enhance the process, the offering to the customer.

Niamh Alexander – Keefe, Bruyette & Woods, Inc.

And does the new VP come from the street, there is some relationships that you haven't had before that you could build or …?

Paul J. Brody

Our new guys name is Bruce Turner and he came from Quadriserv where he was heading up the operations Quadriserv AQS, which is an automated securities lending platform of which we actually have an investment in, we've disclosed that before. We still hope that platform does very well. It's an interesting part of the industry that's hard to automate.

Niamh Alexander – Keefe, Bruyette & Woods, Inc.

Okay, thank you.

Thomas Peterffy

As far as introducing brokers are concerned, this has been a long ambition in my mind that as technology is growing in the overall economy, it certainly is growing in the brokerage business and smaller outfits find it extremely difficult to keep up with their technology needs. And as I have said to some of your firms along with others is that if your executives put their mind to it, they would realize that there are immense savings of getting rid of much of the technology infrastructure that you're using, and you would come on to our platform or maybe on other like ours although I don't know any that is as efficient and inexpensive. So I think that's the song of the future. Brokerage firms, will specialize either in providing technology or providing relationships like the kind of relationships that you're building with your customers.

Niamh Alexander – Keefe, Bruyette & Woods, Inc.

Okay, fair enough. I'll get back in line. Thank you.

Operator

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

Macrae Sykes – Gabelli & Company, Inc.

Good afternoon gentlemen. Not to harp on the Singapore issue, but just more broadly for the margin balances. I guess in general would you say that there the margin balances are diversified across your base or are there still some concentrations there? It just seems like this loss was a big outlier from your average account?

Thomas Peterffy

Well, I am not the person that studied this. We have a department that studies this and I'm told that we have 70 accounts roughly that have fairly large – over $10 million exposure, and the top one is roughly $200 million.

Macrae Sykes – Gabelli & Company, Inc.

Okay. And on the positive note, I was kind of curious about your comments on getting account referrals. So would it be incorrect to assume that as new account growth gets bigger, then in fact, your new account growth percentage could actually increase?

Thomas Peterffy

I'm sorry, you're cutting out, I can't…

Macrae Sykes – Gabelli & Company, Inc.

Sorry, Thomas. So you talked about how a lot of the new account ads are coming from referrals.

Thomas Peterffy

Referrals, yes.

Macrae Sykes – Gabelli & Company, Inc.

Right. So as your base of accounts gets bigger, would it be wrong to assume that your actual growth rate could also get bigger.

Thomas Peterffy

Of course, yes. We get new customers.

Macrae Sykes – Gabelli & Company, Inc.

Great, thank you.

Thomas Peterffy

Okay.

Operator

Thank you. The next question is from Sean Brown of Teton Capital. Your line is open.

Sean Brown – Teton Capital Partners, L.P.

Hi guys, two quick ones. First one is just a follow-up to the gentleman from Gabelli, you said, you have 70 accounts with fairly large exposure; $10 million plus exposure, the top one $200 million. What exactly is that exposure to, if you could clarify exactly what you mean by exposures, that's its overall accounts size.

Thomas Peterffy

We analyzed our accounts with 30% move in the assets that the accounts hold. And then we said that against the amount of money in the account and our biggest exposure is to an account that if the market were to move 30% and we couldn't liquidate, if it suddenly opened 30% lower, we would lose $200 million on that account.

Sean Brown – Teton Capital Partners, L.P.

Got it. Okay, I understand that the concept is much better now. And then my second question is, you mentioned a bit about outside U.S. growth when you touched on the good performance of the introducing broker business line. And I'm just wondering if you could give any more kind of color on how the business is doing outside the U.S., either in Asia or Europe or other regions?

Thomas Peterffy

Well, our biggest introducing broker customers are in Europe specifically. I'm not sure if it's still the biggest. I think now, by now it's in Asia, we have three fairly large introducing brokers in Asia and we have one extremely large one in Europe, and we have about 50 or 60 smaller ones. These are all brokers that recently have come online and they are just driving up. So it looks good.

Sean Brown – Teton Capital Partners, L.P.

And is there a lot of potential to either increase penetration within those brokers or interest in adding new brokers from those regions as they sort of start to hear about Interactive Brokers?

Thomas Peterffy

Well, that's why we have a sales force that goes around to more or likely smaller brokers and tries to talk them into converting to our systems.

Sean Brown – Teton Capital Partners, L.P.

Got it. And are the economics in terms of pretax profit margin or gross margin for Interactive Brokers, attractive similarly to the existing book of business?

Thomas Peterffy

If we break it up by – so overall, our direct expenses comprise roughly 23% of our commission income. And as far as we've discussed it – introducing brokers that happens to be 25%. So, it's slightly less profitable but not in any way out of line.

Sean Brown – Teton Capital Partners, L.P.

Yeah, and I guess because you have such a large fixed cost base on an incremental basis, a lot of that just drops down to the bottom line. So, it sounds like on an incremental basis, it's actually very profitable?

Thomas Peterffy

That is the idea.

Sean Brown – Teton Capital Partners, L.P.

All right, great. Thanks guys.

Operator

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

Deborah Liston

Great. Thanks everyone for joining us today. And just a quick reminder, this call will be available for replay on our website and we'll be posting a clean version of the transcript on our website tomorrow as well. Thanks again for your time and have a great evening.

Operator

Ladies and gentlemen, this concludes today's program. You may now disconnect. Good day.