Interactive Brokers Group (IBKR)

Q1 2016 Results - Earnings Call Transcript

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Executives

- Thomas Peterffy - Chairman and CEO
- Paul Brody – CFO
- Nancy Stuebe - IR

Analysts

- Chris Harris - Wells Fargo
- Rich Repetto - Sandler O'Neill
- Rob Koehn - Ivy Lane Capital
- Doug Mewhirter - Suntrust
- Mac Sykes - Gabelli
- Conor Fitzgerald - Goldman Sachs

Operator

Good day, ladies and gentlemen, and welcome to the Interactive Brokers Group Incorporated First Quarter Financial Results Conference Call.

[Operator Instructions] As a reminder, this conference is being recorded.

I'd like to introduce your host for today's conference, Ms. Nancy Stuebe. Ma'am, please begin.

Nancy Stuebe

Thank you, operator, and welcome everyone to our first quarter earnings call. Our earnings were released today after the market close 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'll take your questions.

As a reminder, today's call may include forward-looking statements which represent the Company's belief 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 on our press release. 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 afternoon everyone and thank you for joining us to review our 2016 first quarter performance.

The quarter was favorably impacted by the decrease in the value of the U.S. dollar relative to the basket of currencies in which we keep our capital and the increase in the mark-to-market value of our short-term treasury securities portfolio in which we invest our customers' cash deposits.

Our pretax profit for the quarter was $376 million. Subtracting $123 million for this quarter’s favorable currency impact leaves $253 million. Of this amount, $235 million was generated by brokerage and $20 million by market making, with the small remainder in corporate.

As we explained in our January earnings conference, in the fourth quarter of last year we had taken a large loss of marking our treasury portfolio to market, and a large portion of that loss, $37 million, came back this quarter. Without this non-recurring item, our brokerage profits would have been $198 million, a new record for the first quarter.

In this quarter we have again seen several other new records for our brokerage business, hitting an all-time high of 345,000 customer accounts, 748,000 Daily Average Revenue Trades, and $70 billion of customer equity. These measures were up 17%, 15% and 15%, respectively, from the year-ago quarter.

Our overall story is unchanging year after year. Our market making business continues to diminish in favor of our brokerage business to the point where in this past quarter 92% of our core operating profits were generated by brokerage and 8% by market making.

In response to the growing onslaught of inquiries, I will give you some statistics of how our brokerage business is evolving across different customer types and different geographic segments. There will be several numbers, so that you may want to grab a pencil and paper or your electronic device as I start.

Our most lucrative accounts are hedge funds and proprietary trading groups. Both of these two financially most sophisticated customer types trade and invest for their own livelihood and depend on our very low transaction cost and prime brokerage capabilities for their income. This is the reason it is so very important for us to keep on top of our order routing algorithms, not to sell our order flow, and not to get into conflicts of interest issues by trading against our customers' orders.

This is why we continuously calculate and publish our customers' all-in execution cost, which for the first quarter of this year was 0.8 of a basis point. To translate that into a more easily understandable number, our customers paid a total of $3.20 to buy or sell 1,000 shares of a $40 stock. The $3.20 includes commissions, regulatory and exchange fees, clearing and custody fees and, most importantly, market impact. This low transaction cost is extremely important because you may be right or wrong when you pick an investment, but the transaction cost you pay will always go against you.

Accordingly, while it is difficult and it takes a lot of homework, analysis and careful thought to pick a winning investment, a much simpler thing any institutional or individual investor can do to improve their performance is to move his or her account to Interactive Brokers.

So as I said, hedge funds and proprietary trading are our most important customer segment, comprising 4% of our accounts, 23% of our customer equity, and 26% of our commission income. We continue to build out our systems with their needs in mind, but as you all know, the great thing about automation is that, once you have built it, it costs very little to run it.

This is the reason that we can make the same low execution cost and the same facilities that we created for this most professional and discriminating traders and investors also available to our individual investor, registered investment advisor, and introducing broker customers. These folks currently and respectively represent 55%, 20% and 21% of our customer accounts, 36%, 27% and 14% of our customer equity, and 50%, 17% and 7% of our commission income.

Now I will repeat all these numbers one more time, to make sure you got them. Hedge funds and proprietary traders have 4% of accounts, 23% of the equity and pay 26% of our total commissions. Individual investors have 55% of the accounts, 36% of the equity, and pay 50% of the commissions. Investment advisors have 20% of accounts, 27% of equity and 17% of commissions. And finally, introducing brokers, 21% of accounts, 14% of equity and 7% of commissions.

Looking at these numbers, you may ask the question: why is it so lucrative for other brokers to go after investment advisors and it isn't so for Interactive Brokers? The simple answer is that we charge much less, much, much less. And the only reason we can afford to be in that business is that it is simply just an addendum to our major business which is to service professional traders and investors.

Over the past five years, individual account holders have come to represent a decreasing share of our overall business, although they are still growing in absolute terms. Hedge fund and prop traders are the fastest growers in terms of commission generation, while introducing brokers open ever more accounts, and registered financial advisors transferred the most amount of customer equity to manage on our platform.

From the point of view of worldwide geographical distribution, it is notable that only 40% of our accounts and only 36% of our new accounts come from the United States. The geographic composition of our client accounts have grown from 20% to 22% in Asia and decreased from 52% to 51% in the Americas, and from 28% to 26% in Europe during the past year.

As far as client equity is concerned, it held steady at 15% in Europe, decreased from 64% to 61% in the Americas, and moved from 21% to 24% in Asia as a percentage of overall equity which, as I said earlier, increased by 15%.

Commission income, while increasing overall 11% year on year, decreased from 57% to 56% in the Americas, 21% to 19% in Europe, and picked up from 22% to 25% in Asia. As you see, we are running a truly global and rapidly growing business that, in some ways, mirrors the global economy. Europe is growing very slowly, the Americas grow a little faster, and Asia is growing the fastest.

But please do not misunderstand, I am in no way suggesting that we need the global economy to continue to grow, in order to grow our business. Our brokerage business will grow in a zero growth or even in a negatively trending global economy for the following reasons:

First, we are the least expensive brokers, and investors switch their accounts to us even more when they are not doing well with other brokers.

Second, the number of high net worth individuals is growing in the developing countries even as the overall economic growth may be slowing.

Third, as money moves from old hands to younger hands, younger people are more inclined to manage their own financial affairs and look for brokers with superior technology and lower cost.

And finally and most importantly, we see that under cost and regulatory pressures, the large established brokers are beginning to turn away or raise prices on the bottom third of their clients, even as in many cases these clients may have millions or tens of millions of dollars in their accounts.

So, all in all, we are looking forward to the coming quarters with great expectations, even as we are extremely frustrated that things are not happening faster. Next year we will be celebrating our 40th year in the business and we must remind ourselves that this is a marathon, and we still have a great distance to cover.

And now Paul, cover some of the distance please.

Paul Brody

Thank you, Thomas, and welcome everyone to the call. Thanks for joining. I'm going to review our summary results. We'll get segment highlights and then we'll open it up to questions.

Overall operating metrics were generally strong for the quarter. Average overall daily trade volume was 1.53 million trades per day, up 19% from the first quarter of 2015.

Electronic Brokerage metrics showed solid increases in the number of customer accounts and customer equity. Total and cleared customer DARTs were up 15% and 17%, respectively, from the year-ago quarter. Orders from cleared customers, who clear and carry their positions and cash with us and therefore contribute more revenue, rose to 92% of total DARTs.

In market making, contract and share volumes were mixed across the product types.

First quarter net revenues were up 184% versus last year, while pretax income rose 404%, for a pretax margin of 69%. Our results benefitted from several trends:

First, market volatility rose. The average VIX rose 20% year over year while actual to implied volatility rose 4%, after exhibiting declines in the fourth quarter. Higher VIX tends to spur volume, driving brokerage revenues, while both measures are positive indicators for our market making business.

Second, the U.S. dollar declined relative to most other major currencies. As a result, the currency basket in which we keep our equity, which we call the GLOBAL, strengthened against the dollar by an unusually large amount. In aggregate, the GLOBAL, as expressed in U.S. dollar terms, rose 2.3% for the first quarter. This resulted in a gain of $123 million, with $84 million reported in Other Income and $39 million in Other Comprehensive Income or OCI. We estimate the total boost to earnings per share from the GLOBAL to be about $0.22 for the quarter, with $0.09 reported as OCI and $0.13 as Other Income.

Finally, medium-term interest rates declined as the Federal Reserve said it would take a cautious approach to rate increases. As a result, mark-to-market gains on our Treasury portfolio, as Thomas mentioned, were $37 million. Although we plan to hold these securities to maturity, we must as brokers, unlike banks, mark them to market quarterly.

Net revenues were $489 million for the quarter, up 184% 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, as mentioned, added $84 million, whereas it produced a loss of $187 million in the year-ago quarter.

Next, the Treasury portfolio marks-to-market added $37 million to our revenues in the current quarter, as compared to adding $13 million in the year-ago quarter.

Finally, hedging of risk on the Swiss franc event that occurred in the first quarter of 2015 resulted in a gain in that quarter of $18 million.

So, adjusting for these factors, on a pro forma basis our total net revenues would be $368 million in the current quarter and $328 million in the year-ago quarter, for a 12% growth rate.

This core growth was driven by higher volume and new account growth, which led to increases in commission revenues; and by higher interest rates acting on greater customer cash balances, which produced more net interest income.

Trading gains were $52 million for the quarter, down 16% from the year-ago quarter.

Commissions and execution fees were $166 million, up 11%.

Net interest income was $127 million, up 37% from the year-ago quarter. Brokerage produced $120 million, with Market Making at $6 million and the remaining amount in Corporate.

Other Income - which as I described earlier includes the effects of our currency diversification strategy and Treasury portfolio marks this year, and those factors plus the Swiss franc event numbers last year - Other Income was $144 million, compared to a loss of $132 million in the prior-year quarter.

Non-interest expenses were $152 million for the quarter, versus $283 million as reported in the same quarter last year. The comparable period number in 2015 would have been $144 million adjusted for the $139 million in customer bad debts on the Swiss franc event. We continue to closely manage our expenses, but we do expect some increases as legal and regulatory burdens rise.

At March 31st, 2016, our total headcount stood at 1,114, an increase of about 3% over the year-end count. We have targeted several key areas for staff expansion, notably customer service, legal and compliance, and software development.

Our reported pretax income this quarter was $337 million, leading to a 69% pretax margin. Excluding the GLOBAL currency and Treasury portfolio mark impacts, our pretax income would have $216 million. This compares with first quarter 2015 adjusted pretax income of $184 million, net of the same factors as well as last year's Swiss franc event. As adjusted, the overall pretax margin was 59% versus 56% last year.

Brokerage pretax profit was a reported 68%, as compared to 18% last year. Adjusted for the items discussed above, brokerage pretax profit was 64% versus 61% in the prior-year quarter. Market Making pretax profit was 34%, versus 40% last year.

Comprehensive diluted earnings per share were $0.60 for the quarter, as compared to a loss of $0.24 for the first quarter of 2015. On a non-comprehensive basis, which excludes OCI, diluted earnings per share on net income were $0.51 for the quarter, as compared to a loss of $0.22 for the same period in 2015. And excluding currency impacts, diluted earnings per share were $0.38 for the current quarter versus $0.13 for the year-ago quarter on the same basis.

Turning to the balance sheet, it 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 March 31st, we maintained over $3.8 billion in excess regulatory capital in our broker-dealer companies around the world, of which about 68% is in the brokerage segment.

We continue to carry no long-term debt and our consolidated equity capital at March 31, 2016 was $5.66 billion, of which approximately $3.7 billion was held in Brokerage, $1.7 billion in Market Making, and the remainder in the Corporate segment.

Turning to the segments briefly. In Electronic Brokerage, customer trade volumes were generally up across the product types. Cleared customer options volumes were unchanged, while futures contracts rose 23%, and stock share volume was up 4% from the year-ago quarter.

Foreign exchange dollar volume fell about 2% from the year-ago quarter. Commission revenue rose on a product mix that featured smaller average trade sizes, which resulted in an overall average cleared commission per DART of $3.86 for the quarter, down 5% from the year-ago quarter, but up 1% sequentially.

Customer equity grew to $70.1 billion, up 15% from last year and up 4% sequentially. The source of this growth continues to be a steady inflow of new accounts and customer assets. As a result, our average account equity is holding steady at about $204,000.

We continue to attract larger customers, along with Financial Advisors that manage groups of smaller accounts, which results in an account size mix that affects both average trade size and average account equity.

Margin debits fell 13% year over year due to customers reducing their leverage during times of higher market volatility. Customer credit balances grew 19% over the year-ago quarter, in line with the rise in overall customer equity.

Net interest income rose to $120 million, up 35% from last year. Interest income benefitted from the Federal Reserve's initial increase in the Federal Funds target rate in mid-December. The $17 million in net interest income from the fourth quarter of 2015 is in line with the estimate of the impact of a 25-basis-point increase that we made at yearend. 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. And we continue to improve our securities lending utilization to capture more revenue from lending hard-to-borrow stocks.

With a growing customer asset base, we continue to believe we're well-positioned to benefit from a rise in interest rates. As noted, the Fed's 25-basis-point increase in the Fed Funds target rate had a beneficial impact on net interest income. And based on current balances, we estimate that a general rise in overnight interest rates of another 25 basis points would produce an additional $48 million in net interest income annually. Further increases in rates would produce smaller gains, because the interest we pay to our customers is pegged to benchmark rates, less a narrow spread.

And a few words on Market Making. Market Making trade volume was mixed across product types. Options contract volume was down 1%, while futures contract volume and stock share volume were up 27% and 56%, respectively.

Trading gains from Market Making for the first quarter were $52 million, down 16% from the year-ago quarter. While market volatility measures were generally favorable, we observed divergence among an unusually large number of individual stocks during the quarter, which had a damping effect on P&L.

Execution and clearing fees expenses were unchanged, and fixed expenses decreased to $23 million, down 4% from the year-ago quarter as we continue to pare down the cost of running this business.

Turning to Corporate, the earnings reported for the Corporate segment reflect the effects of our currency diversification strategy. Our overall equity, as measured in U.S. dollars, increased as the U.S. dollar weakened against most other major currencies. More specifically, we estimate that the overall gain from our strategy of carrying our equity in proportion to the basket of currencies we call the GLOBAL to be about $123 million for the first quarter of 2016. And as I described, because $39 million of this gain is reported as Other Comprehensive Income, this leaves a gain of $84 million to be included in our reported earnings.

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

Question-and-Answer Session

Operator

[Operator Instructions]

Our first question will come from the line of Chris Harris from Wells Fargo. Your line is open.

Chris Harris - Wells Fargo

Thanks, and thanks Thomas, for your comments about geographic dispersion and I guess growth in the business generally. Just a bigger picture question related to that, it just seems like your capabilities are resonating more in Asia than they are in U.S. -- the U.S. and Europe, and don't know if you had any comment as to why you think that might be the case, whether it's just a totally different customer group entirely, if it's driving it, or for just some reason your messaging is resonating with that population to a greater extent.

Thomas Peterffy

I'm very glad that you asked this question. I explained this once before but I'm not sure if it was on an earnings call.

Our biggest enemy is inertia. The issue is that most people with a brokerage account do not want to bother with switching it. So therefore, even if they are -- even if we succeed in convincing them that they would have a financial advantage, a large financial advantage, by bringing their account to us they still don't want to do it, because of just laziness.

And most people in Europe already have an account and most people in the United States already have a broker, right? In Asia, it's the newly rich, the young people who open a brokerage account for the first time in their lives. So they compare the brokers. And anybody who compares brokers can blindly see that we are by far the lowest cost.

So it's not that the message is more – it’s stickier, it's more like the audience is different. And that is the large picture.

Chris Harris - Wells Fargo

Okay. Another sort of question about the long-term growth outlook. If you, I know you've talked before about the number of accounts potentially that you guys could have, but I'm not quite sure exactly who you guys will be taking market share from to get to that sort of end-game. I mean if you look at say Schwab, for example, I mean it's such a different customer group. A lot of those customers wouldn't really care about saving money on trades, they don't trade that frequently. So I'm just having a hard time envisioning how you guys grow that much and who are you exactly taking the share from, I guess, is really the question.

Thomas Peterffy

Fine. So the Schwab customer may not care about saving money on his trades, but the wealth advisor who is with Schwab will, more and more often, have to charge a fixed percentage. Right? And his performance will depend on how much commissions his customers pay. Right? Especially if he turns over the account more frequently than other folks, and those are especially the people whose accounts he would like to get.

So you cannot tell me that people don't care about brokerage expense and especially that they do not care about market impact. It is true that they do not care as much as I think they should, and that's why I'm so frustrated I'm not getting all the accounts that we should be getting, but it takes time and eventually I think that, as you see, we are gaining traction. We are not gaining traction as fast as we should be, but we are. So if we can stick to our 15% growth, we'll be all right.

Chris Harris - Wells Fargo

Got you. Okay. Thank you for that.

And Paul, just a quick numbers question. You guys are pretty clear that Treasury gains added $37 million to revenue. What is the -- what is the EPS impact of that gain?

Paul Brody

Well, you could probably the math, I think it was somewhere around $0.06 or something like that.

Chris Harris - Wells Fargo

All right. Thank you.

Operator

Thank you. Our next question will come from the line of Rich Repetto from Sandler O'Neill. Your line is open.

Rich Repetto - Sandler O'Neill

Good evening, Thomas; good evening, Paul.

Thomas Peterffy

Hi, Rich.

Rich Repetto - Sandler O'Neill

I guess the question first is on net interest income. You had strong results and I appreciate the incremental information, Paul, on the impact of the rate hike. But when you look at it, I think the guidance was $57 million for the first 25 basis points, and I guess the question is, can you give us a little bit more breakdown, because it seems like you were up when, beyond that: divide 57 by 4, you were up beyond that with margin loan balances going down. And it's just challenging to understand what's going on in that, you know, could it be incremental interest from the Treasuries that you earn, etc., or?

Paul Brody

Right, right. So the $57 translates into about $14 a quarter. The increase over the fourth quarter was $17. Our credit balances have been up steadily. And so most of it is on the credit balances themselves, a little bit maybe the stock loan component is roughly unchanged, it's holding steady. And yes, the debit balances were down, so it's going to be in the investment of the credit balances. We've gone out the yield curve a little bit, that's partly why you see those mark-to-market gains and losses from quarter to quarter. But that's the story, it's $17 versus a predicted $14, had nothing else changed.

Rich Repetto - Sandler O'Neill

Okay. And I guess one other, before I get to a question for Thomas, but one other small accounting question. So if you back out the Treasury gain as well as the FX marks in that Other, you come up with $23 million, and it's a little bit below. I thought you talked about it running at about $30 million. Anything in particular going on there, in the Other Income line?

Paul Brody

Oh, you were talking about run rate for other income?

Rich Repetto - Sandler O'Neill

Yeah. I thought it was -- I thought you'd said $30 million on the last quarterly call.

Paul Brody

I don't recall, but there was -- I don't think there are any other extremely notable items going on in other income. You know, we could hone in a little bit more and we'll probably give a little bit more detail when we get around to the 10-Q.

Rich Repetto - Sandler O'Neill

Okay. And --

Thomas Peterffy

When you're looking at interest income, you should include the fact that we spend a lot of energy on trying to maximize our interest income from our stock portfolio.

We have put in a great deal of automation that is extremely helpful in maximizing our stock loan interest income.

Rich Repetto - Sandler O'Neill

And, qualitatively, was that up quarter to quarter, your stock loan book revenue?

Thomas Peterffy

Yes.

Rich Repetto - Sandler O'Neill

Interesting. And Thomas, I guess a question on, you know, some of the information that you've given, it's fantastic, the breakout. But on the introducing brokers, if they are growing, I guess the fastest from an accounts standpoint, I mean, would we expect, because I think you said in the last call, you gave a lot of these introducing brokers a significant discounted commission so they can make a profit. Would we expect the average commission to go down with their growth, given that they're growing the fastest?

Thomas Peterffy

If introducing brokers, not per account, but if introducing broker trades grow faster than hedge funds and prop trader trades, then, yes. But on the other hand, if prop traders and hedge funds by trades grow faster than introducing brokers, then you will see an increase in average commission. And not just from the hedge funds and prop traders, but also from individual traders.

Rich Repetto - Sandler O'Neill

And the price relief that you give introducing brokers, is it pretty much the same? I thought you'd mentioned the 80%, they're getting commissions at about 20% of what you charge.

Thomas Peterffy

They are getting a steal, Rich.

Rich Repetto - Sandler O'Neill

Okay, all right. I won't ask any more questions on that.

One last one though. The number of initiatives that you talked about last time, whether it be Covestor or be it in the Investor Marketplace, any one particular -- any updates on any of these sort of function -- platforms that you're introducing any updates on -- to note of in the quarter?

Thomas Peterffy

Well, I don't really have any updates. It is growing some but slower than we have expected. I think that our Marketplace is taking off fairly well. But Covestor so far is a disappointment. But we're going to stick with it and, you know, it always takes a long time to get anything going. But eventually - we have never ever failed at anything. So we will succeed here too.

Rich Repetto - Sandler O'Neill

Got it. Okay. Thanks very much, it's very helpful.

Operator

Thank you. Our next question will come from the line of Rob Koehn from Ivy Lane Capital. Your line is open.

Rob Koehn - Ivy Lane Capital

Thank you. Thanks, Thomas, for taking my call.

You mentioned the stickiness of the platform. On a monthly basis we see these net new customer accounts, and I'm sure that you don't share gross adds and the dilutions such as net adds on purpose, but is there anything you can say, I mean, any trend that you've seen with regard to the stickiness of the business, particularly among the larger accounts?

Thomas Peterffy

You're not quite correct because I think that last quarter I did say that, for the year, the number of closed accounts were, I think I remember correctly, 46% of all the new accounts. So for every 100 accounts, 100 new accounts that are funded, 46% were lost, 46 accounts were lost.

Rob Koehn - Ivy Lane Capital

Okay. I don't recall having heard that. But is there any particular trend over the last six or seven years, or longer, since you've been a public company that you would point to in that regard?

Thomas Peterffy

I, to tell you frankly, I haven't been keeping track up until the last two years and it's been holding pretty steady, because the primary cause of our closing accounts is that people run out of money. And you have to remember that, in spite of the fact that the average account size is $204,000, more than half of our customers have less than $24,000 in their accounts, and a third have less than $10,000.

Rob Koehn - Ivy Lane Capital

Right, right.

Thomas Peterffy

We have very, very few accounts transferred to another brokerage firm. I think that it's in the neighborhood of like 300 in a month, out of 4,000 new accounts. And most of those people that transfer, transfer because they change -- they are usually registered investment advisor accounts and they change investment advisors. So that's -- they change investment advisors, or in some cases there are deaths, and that sort of thing. So we lose very few accounts because people are unhappy with our service.

Rob Koehn - Ivy Lane Capital

Right, okay. That's good.

And then somebody asked earlier a question about geographic trends. What have you -- I noticed you've been spending a lot of effort in upgrading the mobile trader workstation product. What are the trends in mobile usage? If you go from North America to Asia, to Europe, just broadly and geographically, is there any notable increase there?

Thomas Peterffy

I'm sorry, but I -- we haven't -- I haven't tracked mobile geographically. I know that mobile overall is rising, it's not rising as fast as we expected, and I haven't tracked it geographically.

Rob Koehn - Ivy Lane Capital

Great. Okay. Okay.

And then just last question, when you talk about Asia, when you think about Asia, I think a lot of people think about China and Singapore. To what extent - and I know that you've said no, you don't want to break this out in the past - but what about India, I mean, and Australia, Japan?

Thomas Peterffy

You have to understand that Asia for us includes Australia and Japan of course, and India and Malaysia and Indonesia and the Philippines. Hong Kong and Singapore are both big contributors. So, China itself is not the largest participant here.

Rob Koehn - Ivy Lane Capital

Would it make sense, do you think, just to kind of put India in a separate category, or is that not big enough yet to merit doing?

Thomas Peterffy

Well, India is a bureaucratic problem and they have high interest rates and we have difficulty paying interest to the customers, because they do not know how to earn sufficient interest, and so it's not -- it's a bureaucratically difficult place to do good business.

Rob Koehn - Ivy Lane Capital

Got it. Okay. Thanks very much. Appreciate it.

Thomas Peterffy

Thank you. Our next question will come from the line of Doug Mewhirter from Suntrust. Your line is open.

Doug Mewhirter - Suntrust

Hi, good afternoon. I just had two questions. First, could you explain a little bit on the Market Making operation what "divergence" means? And also to -- just to add to that question, I would imagine that higher volatility would be -- I thought it would have been a higher opportunity for more profits, or is it just that the variability of Market Making profit is higher, in a higher, volatile environment?

Thomas Peterffy

Well, I don't know why we use the word "divergence", so I don't know what you're referring to. It normally means to deviate from each other. But as far as the higher volatility, a higher volatility should be good for market making, as you see the entire Street was suffering as far as trading profits were concerned. So what happens here is that we only trade on exchanges and on exchanges we are - unlike Goldman Sachs or Morgan Stanley - who have the customer at the other end and they can give them practically any price they want to, we have to compete with other professionals on the price that we try to trade at. And that competition has been getting heavier and heavier because there are numerous hedge funds that have come into this business. And it's getting more and more difficult.

Now if you would remind me what "divergence" has to do with, then I will try to answer you.

Doug Mewhirter - Suntrust

I'm just reading -- in your press release you said the Market Making segment income, before income taxes, decreased 26%, "primarily driven by divergence among a significant number of individual stocks".

Paul Brody

So I can add a little bit of color there.

Thomas Peterffy

Oh, right, yeah. Okay. I don't know why we put that in there. The way we run this business is that we assume that stocks will move according to their historical correlations. And when they do not, then we do less well. But most of all I think that this refers to corporate actions, when inside information is being front-run by people who are plugged in better than we are.

Doug Mewhirter - Suntrust

Okay, thanks for that. My last question deals with the prime brokerage business. In your new prime brokerage accounts that you've won, are you noticing that, I guess bulge brackets and regional investment banks are increasing the minimums on the customers? So, are you getting higher-value hedge fund accounts?

Thomas Peterffy

That's correct. We do get higher-value accounts. That's what explains that even though we have big growth in introducing broker accounts who pay little commissions and have small account equity, the high-value accounts and the hedge fund side counterbalance, and that's why our commissions overall are dropping, and our average account equity is not dropping.

Doug Mewhirter - Suntrust

Okay, thanks. That's all my questions.

Operator

Thank you. Our next question comes from the line of Mac Sykes from Gabelli. Your line is open.

Mac Sykes - Gabelli

Good evening, gentlemen. Just going back to the Asian account business. Which products and geographic regions are they choosing to invest in? And is there a difference in profitability for cross-border transactions?

Thomas Peterffy

Well, some -- yes. So, commissions are higher. The commissions we charge are higher outside the United States than inside the United States. However, most of our customers do trade inside the United States, so an Asian customer will pay exactly the same as a U.S. customer will pay for the same trade. There is no difference there. Asian customers trade U.S. stocks and options, and also perhaps even heavier in futures, than U.S. or European customers do.

So there is not -- there is not a tangible difference there.

Mac Sykes - Gabelli

Understood. And I mean, are you seeing, in terms of the trends, where people are staying within their regional focus or is there….

Thomas Peterffy

No, no. I said that Asians are trading in the United States to a surprisingly large extent. The bulk of their trading is within the United States.

Mac Sykes - Gabelli

Okay. I mean you've done a fantastic job generating capital, I mean, at 3.7 billion at the brokerage unit. Thinking about this in another way, if we were to use up all the excess that you have, what would that mean in terms of total client equity capacity? So in other words, at this point, if you were to bring on AUC, how big could you go given the present amount of capital?

Thomas Peterffy

Paul, you want to take a crack at this?

Paul Brody

Well, there's a lot of moving parts there, Mac. You know, it depends on how much money you're lending to customers, because general rules in the United States are that the broker has to set aside 3% of debits, and so there's -- it's capital ratios, right? So, brokers are able to get more leverage than banks these days, so that gets us some advantage, lending against fully marginable securities. But it would depend on how much of the expansion takes that form, and then of course how much, on the commodities side, how much is being put up in risk margin and so forth, so there are limitations. But we clearly have plenty of capital to expand, and the reason we leave it in the business is just for that reason, we want to be opportunistic, take advantage of when the markets are very active and we can actually support more business, and so forth.

Mac Sykes - Gabelli

Okay. And, I mean, it seems like it's many multiples of the current $70 billion of AUC. I'm just curious, you mentioned that you optimized --

Thomas Peterffy

That is correct. It's several multiples of the current $70 billion, yes. It largely depends on how much margin borrowing is needed.

Mac Sykes - Gabelli

Right, right. And then the last thing is, you talked about how you really focused on optimizing sort of the interest income and some of the benefits of your platform. Given the trajectory of your capital generation and the buffer and so on, I mean, is there any point where you, you know, you'd think about the ROEs and the capital at some point, strategically you think about those returns and whether you would want to return more than the current amount from market making?

Thomas Peterffy

Mac, I'm obsessed with trying to grow this to become the largest brokerage in the world. That's the only thing I care about. I don't care about the returns.

Mac Sykes - Gabelli

OK. Good luck. Thank you.

Operator

Thank you. Our final question will come from the line of Conor Fitzgerald from Goldman Sachs. Your line is open.

Conor Fitzgerald - Goldman Sachs

Thanks for taking my questions. Paul, maybe just one for you first. I think you mentioned in your prepared remarks some increases in regulatory and legal burdens maybe impacting your expense base. Can you help us understand what's driving those expenses and maybe just help us size the magnitude of the increase?

Paul Brody

Sure. Well, Conor, you work for Goldman Sachs, I'm pretty sure you're well aware of the regulatory environment that we're all faced with, an increasing burden on meeting new compliance requirements all the time. But in our case, really what -- I mentioned it because we're focused on increasing our legal and compliance staff. So our staff is generally small to begin with, given how we're supporting over 100 market centers in 24 countries around the world. And so for us to add a handful of people is more meaningful than it would be to a much larger company.

Conor Fitzgerald - Goldman Sachs

That's helpful, thanks. Then maybe one for you, Thomas. I think the DOL released their final fiduciary rules recently. I guess, do you see this kind of as an opportunity for you to grow your RIA business, and if you do, can you talk about what you think would be necessary from either an investment or maybe a compliance cost to kind of seize the opportunity?

Thomas Peterffy

So, we are working on automating our Registered Investment Advisor compliance set of rules. Because we want to eventually offer to Registered Investment Advisors that we will take care of their compliance needs from beginning to end. We can do some of that right now and we keep growing that capability.

So, since we're looking at this as a business, the more new regs come down for these customers, I think the better off we'll be, because the fewer competitors we will have.

Conor Fitzgerald - Goldman Sachs

That's helpful. And any other impacts from the DOL's final rule on your business that we should be thinking about? One or two competitors talked about just having to go over some of their compliance procedures around education or trading advice, any impact for you guys?

Thomas Peterffy

That's a thing we continuously do all the time. So there's nothing that is very different.

Conor Fitzgerald - Goldman Sachs

All right. Thanks for taking my questions.

Thomas Peterffy

Thank you.

Operator

Thank you. I would like to turn the call back over to Nancy Stuebe for any closing remarks.

Nancy Stuebe

Thank you, everyone, for participating today. As a reminder, this call will be available for replay on our website. We will also be posting a clean version of our transcript on our site tomorrow.

Thank you again and we will talk to you next quarter-end.