

# **Interactive Brokers Group's (IBKR)**

## **Q3 2020 Results - Earnings Call Transcript**

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### **Executives**

**Thomas Peterffy - Chairman**

**Paul Brody - CFO**

**Nancy Stuebe - Director, IR**

### **Analysts**

**Will Nance** *Goldman Sachs*

**Chris Harris**, *Wells Fargo*

**Kyle Voigt** *Keefe, Bruyette, & Woods*

**Rich Repetto**, *Piper Sandler*

**Chris Allen**, *Compass Point Research*

**Craig Siegenthaler**, *Credit Suisse*

### **Operator**

Ladies and gentlemen, thank you for standing by, and welcome to the Interactive Brokers Group Second Quarter Financial Results Conference Call. At this time, all participant lines are in a listen-only mode. After the speakers' presentation, there will be a Q&A session. To ask a question during the session, you will need to press "star one" on your telephone. And now I would like to introduce you to our host for today's program, Nancy Stuebe, Director of Investor Relations, please go ahead.

**Nancy Stuebe**

Good afternoon, and thank you for joining us for our third quarter 2020 earnings conference call. Thomas will handle the beginning of the call and the Q&A, but asked me to present the rest of his comments.

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 in our press release. You should also review a description of risk factors contained in our financial reports filed with the SEC.

Thomas, please go ahead.

**Thomas Peterffy**

Good afternoon. Early last year, I spoke about what is going to happen to my Interactive Brokers shares. As I said at that time, and repeat now, I'm a firm believer in the long-term success of this company. And I'm a reluctant seller but must recognize the 2 issues I'm frequently asked about. One is the small float that scares away large would be purchasers of the stock. And second is the taxes on death that could force liquidation.

In order to show some movement to deal with these 2 issues, but also to keep holding on to most of my stock, I will start a selling program that would dispose of the shares gradually over the next 60 years. I will implement a trading program that sells 20,000 shares on each business day. As our average daily volume is roughly 600,000 shares. These shares are not expected to have much of an impact on the price. I will start the daily sales of 20,000 shares every business day trying to achieve the daily VWAP. I have been approached by several potential investors and brokers who offer to buy a block of stock, but my answer is always the same, and it will remain the same. If you want the stock, you need to buy it in the open market.

Second is Brexit. As a global broker, we operate in legal and regulatory environments of many localities, countries and regions. On this ever-shifting landscape, we find we must adapt our operations, including our corporate structure and operating licenses to continue servicing our existing and new clients at high levels. This is, in particular, a focus in Europe in the context of Brexit. U.K. and the EU negotiations over Brexit have been ongoing for several years, with more than a few changes in direction and postponements of the effective date.

If the current withdrawal agreement is honored, Brexit will become effective on December 31 of this year. As we conduct our European business primarily through our U.K. broker and to a lesser extent through our Luxembourg broker, we have applied for additional licenses in Europe through our affiliates: Interactive Brokers Ireland and Interactive Brokers Central Europe. While we have been at this effort for some time, our license applications are pending for both affiliates. And we think it's quite possible that 1 or both will still be in progress on December 31.

While the outcome depends on many factors, including regulatory flexibility and interpretations, it is possible that we will be facing a temporary gap during which we could be unable to fully service some EU customers for a short period of time, subsequent to the year-end, which could negatively impact our business in Europe. We think that any delay in our ability to service affected EU clients or open new accounts would be limited and temporary.

The third item is margins. Much has been made of our recently announced policy to slowly increase certain margin requirements in the run-up to the election. Given the uncertainty over the market during this time, we believe this is the correct, prudent step to take to protect our customers and ourselves. We have given more than sufficient notice of our intention and we are implementing the increase very gradually and do not see any major issues.

And now back to you, Nancy.

### **Nancy Stuebe**

Thanks. In the third quarter, we continue to see strength in our business as more and more people in countries around the world chose to invest in the markets. Accounts rose 47% year-on-year to

981,000 as we added 105,500 net new accounts in the quarter. Client equity grew by 49% to \$233 billion as new and existing clients worldwide sought to take advantage of the market opportunities they saw. Growth came in all client segments in all geographic regions, with areas outside the U.S., particularly strong once again. This international growth continues to result in a more even customer distribution among the countries and regions that we serve.

Over the course of the quarter, clients grew more comfortable with putting money into the market and taking on leverage with margin loans growing from \$24.9 billion at June 30 to \$30 billion at this quarter end. As clients traded more actively during this period of high market volatility, our total DARTs reached over 1.8 million, more than doubling from last year. And cleared average DARTs per account rose 49% to 442. Because our platform is highly automated, the marginal cost of adding an additional client diminishes as we reach higher account numbers. The limit to this diminishment in marginal cost is the expense of KYC and other compliance obligations we have, which are especially high with respect to customers in foreign jurisdictions. This expense we can regard as a fixed cost to add a new account.

To the extent the profit derived from such a new account exceeds these fixed costs, we continue to focus on growing our new accounts. Automation also enables us to offer worldwide access to financial instruments ranging from equities, fixed income, funds, derivatives and FX, among others giving us the diversity of products to attract customers from all geographies. Since the Federal Reserve lowered interest rates to near 0 in March, our net interest income has been affected. Higher-margin loans and influx of cash into new and existing customer accounts and a strong securities finance performance led to \$195 million of net interest income for the quarter despite our segregated cash and securities yielding only 13 basis points. We continue to invest our segregated cash in the safest short-term securities as a flat yield curve with near 0 interest rates means there is no advantage to buying long-term securities or taking on the risks that non-U.S. treasury investments bring.

Finally, our total equity surpassed \$8.5 billion in the third quarter, our highest to date. With no debt, our balance sheet remains solid as we continue to grow, our strong equity capital helps us

attract larger international and institutional clients. Once again, we saw growth in all 5 of the client types that we service.

I will now go over our 5 client segments.

Individual customers, which made up 56% of our accounts, 36% of our client equity and 54% of our commissions continued to be our fastest-growing segment, with 12-month account growth of 65%, client equity growth of 54% and 42% growth in latest 12 months commissions. All geographic regions we serve saw account, client equity and commissions grow over 30%, with international growth from Europe and Asia outpacing the Americas for now. Global investor demand for a reliable platform with a wide choice of products in international markets continues as investors seek to maximize their investment opportunities.

Proprietary trading firms are 2% of our accounts, 10% of client equity and 14% of commissions. For the quarter, this group grew 22% in accounts for the 12-month period, 35% in client equity and 29% in commissions. Prop trading firms are sensitive to the direction of volatility and the quarter's high volatility offered them numerous opportunities. Prop traders also tend to have more active trading strategies, which benefit from our low-cost platform that provides access to securities around the globe. But most importantly, proprietary traders depend on trading profits, and execution quality is a major determinant of trading profits. This is what attracts most prop traders to our platform.

Hedge fund accounts for the 12 months ended September 30, grew 2% in accounts, 27% in customer equity and 8% in commissions. Hedge funds represent 1% of our accounts, 7% of our client equity and 8% of our commissions. We are pleased to see 27% growth in customer equity as the hedge fund industry's assets under management have been flat for about 2 years now. So our growth here indicates strong results in a flat industry. Growing word of mouth, a reputation for best price execution and low-margin rates, and the quality of our platform are behind this growth.

Financial advisers are 12% of our accounts, 18% of our customer equity and 13% of our commissions. This group grew accounts by 14% for the 12-month period, while customer equity rose 17% and commissions 7%. As advisers tend to be more conservative in their activity, their commission growth tends to grow more slowly in periods of high volatility. After quarter end, the back-to-back closings of 2 industry transactions meant fewer competitors in the space. We continue to see opportunity in this area. With fewer competitors, it is easier to get visibility when both new and existing FAs research their platform options, especially when they hear about new fees, learn about hidden fees and potentially find themselves competing against their broker.

Our final segment is introducing brokers. These represent 30% of our accounts, 29% of our client equity and 12% of our 12-month commissions. I-broker segment account growth was 38% for the latest 12 months, with 86% client equity growth and 71% in commissions. We saw growth in this segment in all regions, with Asia showing particular strength. Because we offer global markets and products, along with seamless back office functionality, we can grow in regions where customers may not be large enough to draw the attention of bulge bracket banks, or even if they did, would be charged extremely high prices for international access. In 2020, as more people worldwide thought to invest or to diversify their assets, they wanted the ability to access many markets and products in their search for returns and asset safety.

Turning to new products. Offerings this quarter included our new Impact Dashboard, which helps investors evaluate their portfolio so they can make adjustments and invest in companies whose ESG world views correspond with their own. As ESG investing grows in importance and in assets allocated, Impact Dashboard allows our clients to select the principles and practices most important to them, and then see how each individual investment in their portfolio moves them closer to, or farther from, their goals.

Our Mutual Fund Marketplace has grown to over 34,000 no-load mutual funds from over 285 fund families, making Interactive Brokers one of the largest, if not the largest, fund agnostic supermarkets. As always, we do not charge a custody fee and the funds can be accessed by our clients at over 200 countries and territories.

We have been spending more on advertising and continue to see good response to our digital marketing efforts. In fact, Google AdWords is using Interactive Brokers as a case study in successful digital marketing efforts.

For years, ever since we started our electronic broker in 1993, our dream was 1 million accounts. And sometime within the next week, we will welcome our 1 millionth client. Our goal now is to achieve 80 million accounts or 1% of the global population. To do this in 20 years would be a 25% annual growth rate. To do this in 10 years is a 55% growth rate. There is 1 country today where Interactive Brokers has a nearly 1% share of the population, clearly indicating that 1% or 80 million worldwide is not an impossible dream.

With that, I will turn the call over to our CFO, Paul Brody, who will go through the numbers for the quarter. Paul?

### **Paul Brody**

Thank you, Nancy. Thanks, everybody, for joining the call. As usual, I'll first review our operating results and noncore items. Then my comments will follow the format of the earnings release, after which we'll open up the call for questions.

As a reminder, starting this year, we began reporting without separate business segments as our remaining market making activity is no longer material to our overall result. We also separated other fees and services from other income. Other fees and services contains recurring items such as market data fees, account activity fees and FDIC Bank Sweep Program income. And other income consists of items that are less predictable in nature, like currency impact, U.S. treasury marks to market, principal trading activities and other investment gains or losses.

Looking at the operating data, high trading volumes and customer account openings continued as volatility, still at elevated levels, moderated from the second quarter. The continued global impact of the coronavirus as well as uncertainty over the upcoming U.S. election and Brexit are likely contributors to highly active markets worldwide. Volatility, as measured by the average VIX, rose 62% to 25.9 in the current quarter from 15.9 in the same quarter last year. However,

while the VIX peaked at 34, the current quarter was less volatile than the first and second quarters of 2020 when the VIX spiked to 82 for a short time in March and to 57 in April. Quarterly total DARTs increased 113% to a record \$1.8 million compared to the third quarter of 2019, and our customer trade volumes continued to rise dramatically in every product class, led by increases of 65%, 9% and 109% in options, futures and stocks, respectively. FX dollar volumes were strong as well, increasing over 30%.

Total accounts reached 981,000, up 47% over the prior year, with quarterly net new accounts added at a pace once again about 5x higher than last year's quarter. This contributed to client equity growth of 49% to \$232.7 billion at quarter end. Our overall average cleared commission per commissionable order fell 27% versus last year to \$2.69 due to a product mix that featured smaller average trade sizes across all product classes.

Smaller trade sizes are often seen in high volatility periods as traders choose to risk less per trade in fast-moving markets. We also saw higher exchange rebate which we passed through to our client in the form of lower commission as our strong order volume led to our capturing incentives offered by exchanges on liquidity providing orders.

Overall, higher commission revenue show that the strong increase in trade volumes more than made up for the drop in commission per commissionable order.

Moving to our net interest margin table. Net interest margin narrowed from 1.77% in last year's quarter to 0.94%. The Federal Reserve brought its benchmark target rate down to near 0 in March and has kept it there. The average effective Fed funds rate, which we use to price both margin loans and interest paid on customer cash fell from 2.19% in the third quarter of '19 to 0.09% in the third quarter of '20. While significantly lower rates reduce what we pay on our customer credit balances, they also reduce what we earn on segregated cash and margin loans.

Nevertheless, our net interest margin narrowed just 83 basis points over this period, supported by margin loans and strong securities lending.

Despite the Fed lowering the overnight interest rate, the yield curve remains fairly flat as it has



for several quarters. We have kept the duration of our portfolio relatively short and recorded a mark-to-market loss of \$2 million on our holdings of U.S. treasuries, similar to last year's third quarter. As always, we plan to hold these securities to maturity. So any gains and losses on our marks to market each quarter should trend towards 0 over time. But as brokers, unlike banks, GAAP rules require that we mark our portfolio to market in our financial reporting.

Outside the U.S., benchmark interest rates remained near or below 0 for many currencies as central banks continue to attempt to soften the impact from COVID-19 on their economies. Despite a 28% increase over the year ago quarter in average customer credit balances, the reduction in interest expense paid on these balances was the largest contributor, preventing our net interest margin from falling further. Not only our most credit balances paid 0 interest, some balances in negative rate currencies produce revenue on the pass-through to some customers. We continue to have success in asset gathering. And our FDIC insured bank deposit sweep program, held an average of \$3 billion a year, up \$800 million from last year.

Margin lending and securities lending were the largest contributors to our net interest margin. Average margin loan balances rose 9% from last year. However, due to significantly lower benchmark interest rates, margin loan interest income fell 53%. Margin loans have shown a steady climb back, ending the quarter at \$30.3 billion, up 17% versus last year and up 18% from the second quarter. Securities lending interest income was up 12% this quarter versus a strong year ago quarter as we continue to execute on hard to borrow names that investors were looking to short.

On segregated cash, despite a 48% increase in segregated cash balances, lower investment rates led to a 91% decline in interest income. Several factors caused the yields on our segregated cash to differ from the change in the Fed funds rate. First, the portion is held in other currencies; and second, given an average duration of the investment in treasuries of about 44 days, reinvestments take place over time. So some of our investments in segregated cash would not be expected to follow Fed rate declines immediately. We are approaching the tail end of our investments at higher rates and maturity of the small amount remaining will not have a material impact on our overall investment rate.

The increase in segregated cash balances is primarily a function of credit balances growing at a faster rate than margin loans and net investment purchases. While investors continue to take on leverage this quarter, the steady consistent growth in our clients' cash outpaced the growth in both of these factors. Note too that the FDIC Sweep Program removes funds that would otherwise be included in our segregated cash balances from our balance sheet for accounting purposes.

Now for our estimate of the impact of the next 25 basis point increase in rates. When calculating the impact of rate changes, we understand that as the possibility of a future rate increase becomes more certain, this expectation typically is already reflected in the yields of the instruments in which we invest. Therefore, we attempt to isolate the impact of an unexpected rise or fall in rates, separate from the impact of rate hikes or cuts that have already been baked into the prices of these instruments.

With that assumption, we would expect the next 25 basis point unanticipated rise in rates to produce an additional \$94 million in net interest income over the next 4 quarters and \$103 million as the yearly run rate based on our current balance sheet.

These numbers are highly sensitive to benchmark rate changes due to the impact of low rates on the spread between what we earn on our segregated cash and what we pay our customers. As U.S. rates fell below 50 basis points, our spread compressed as we earn less when investing our segregated cash. However, the converse is also true that as rates move back up toward 50 basis points, our spread expands significantly.

The run rate includes the reinvestment of all of our present holdings at the new assumed rate, but does not take into account any change in how we manage our segregated cash. If we are successful in continuing to grow our customer assets, higher cash and margin lending balances, will provide some offset to the loss of net interest income from low benchmark rates, should they persist.

Turning to our income statement. As I mentioned earlier, in 2020, we began reporting our consolidated numbers only and no longer report segment. We define noncore items as those not

part of our fundamental operating results. Noncore items, included 3 items this quarter: first, our currency diversification strategy produced a gain of \$27 million versus a \$47 million loss last year; second, mark-to-market loss on U.S. government securities of \$2 million, the same as the prior year; and third, a gain on our investments of \$5 million versus a loss of \$10 million last year. The net effect of these adjustments raised pretax income by \$30 million this quarter versus reducing it by \$59 million last year.

Net revenues were a reported \$548 million for the quarter, up 18% versus last year's third quarter. Excluding noncore items, net revenue was \$518 million, down 1% versus last year. Commission revenue rose 49% on significantly higher trade volumes in all product categories. Net interest income fell 33% to \$195 million, though it was about even with the second quarter. The decline was largely due to the drop in the average effective Fed funds rate versus the year ago quarter. Other fees and services revenue rose 29% to \$45 million. These include market data, exposure, account activity and FDIC bank sweep program fees, as well as fees generated from facilitating customers' participation in IPO's.

Other income, which includes the gains and losses on our investments and currency strategy as well as principal transactions, was \$29 million versus a \$47 million loss last year, that was primarily due to currency effects on the GLOBAL. Ex noncore items, other income decreased from a gain of \$12 million to a loss of \$1 million this quarter. This includes a \$13 million loss on our investment in the OneChicago Exchange, which ceased operations in September.

Noninterest expenses were \$214 million for the quarter, up 16% from last year due primarily to higher execution and clearing costs, in line with higher trade volume. Also, higher employee compensation and benefits costs and \$3 million in customer bad debt versus a \$2 million recovery last year. At quarter end, our total headcount stood at 1,923, a 22% increase over last year. Due to the COVID-19 pandemic, most of our employees worldwide have been working remotely. After a brief pause in the first quarter, we have been hiring again to keep up with the influx of new accounts and to strengthen client services, compliance, and systems development for the future.

Fixed expenses were \$137 million, up 15% driven by higher compensation and benefits as well as some increase in occupancy.

G&A expenses were up 23%, a substantial portion of which were expenses associated with the development of, and consultants for, our compliance program. While the increase in compliance staff has raised our compensation and benefits expenses, we believe that most of the cost of outside consultants has been recognized and will not be recurring. Customer bad debt expense was \$3 million, well within the \$0 to \$5 million we expect in any given quarter and well-contained despite the increase in activity and volatility. Reported pretax income was \$334 million, up 19% despite a \$96 million drop in net interest income for a 61% margin.

Excluding noncore items, pretax income was \$304 million, down 11% for a 59% pretax margin. Diluted earnings per share were \$0.58 for the quarter versus \$0.45 for the same period in 2019. And ex noncore items, diluted earnings per share were \$0.53 versus \$0.57 last year as adjusted.

To help investors better understand our earnings, taxes and the split between the public shareholders and the noncontrolling interest, third quarter numbers are as follows: starting with our unadjusted pretax income of \$334 million, we deduct \$18 million for income taxes paid by our operating companies, which are mostly foreign tax. This leaves \$316 million, of which 81.2%, or that \$256 million reported on our income statement, is attributable to noncontrolling interest. The remaining 18.8% or \$60 million is available for public company shareholders. As this is a non-GAAP measure, it is not reported on our income statement. After we expense remaining taxes of \$14 million owed on that \$60 million, the public company's net income available for common stockholders is the \$46 million you see reported on our income statement. The income tax expense line of \$32 million consists of this \$14 million, plus the \$18 million of taxes paid by the operating company.

Two additional notes on operating companies income tax. The current quarter tax includes about \$5 million in prior period adjustments that are not expected to be recurring. And second, the current rate is running about \$1 million per quarter higher than previously due to increased tax costs outside the U.S.

Turning to the balance sheet, with \$8.5 billion in consolidated equity, we are well capitalized from a regulatory standpoint. We deploy our strong capital base toward opportunities to grow our brokerage business worldwide as well as to emphasize the strength and depth of our balance sheet, to current and prospective clients and partners.

We continue to carry no long-term debt. And at September 30<sup>th</sup>, margin loans were \$30.3 billion, up \$4.4 billion versus last year. We continue to expect swings in margin lending balances, reflecting both economic conditions and our success in attracting institutional customers who are more opportunistic in taking on leverage. We offer the lowest margin lending rates of our competitors. And as we expand our customer base, we remain well-positioned to satisfy our customers' risk appetite.

Now I'll turn it over to the moderator, and we will take questions.

## **Question and Answer Session**

### **Operator**

(Operator Instructions)

Our first question comes from the line of Rich Repetto from Piper Sandler, your question please?

### **Rich Repetto**

Yes, good evening Thomas, good evening Paul. So first question, Thomas, is trying to put a sort of a quantity around or quantify the risk of the EU and not getting the broker approval. Is there any way you can talk about potentially how it could impact either revenue or DARTs if you didn't get certain brokers approved?

**Thomas Peterffy**

I don't think that the impact would be noticeable. I think it would be only noticeable to the extent of opening new accounts. And their trading. So I don't expect that it will make much of a noticeable impact in the numbers.

**Rich Repetto**

Because I am assuming the other existing accounts could still continue to trade.

**Thomas Peterffy**

That's right.

**Rich Repetto**

Okay. Another question. The margin loans have dramatically increased since they bottomed in March at a little bit over \$30 billion and sort of roughly flat with sort of the higher quarters of last year. But I guess my question -- can you see the margin loan balances -- given that accounts have grown by 50%, and to the best of our ability, when you look at average client equity or average trading, it's still the same. So are you -- can you expect to see an improvement in people starting to lever up more?

**Thomas Peterffy**

I do expect that but you must consider the fact that, number one, many of the new accounts are less of the professional trader type that we originally had and more of the investor type. So they tend to use less margin. And second, we have tightened up many of our requirements because of understandable reasons, right?

**Rich Repetto**

Yes. Expected volatility here. But I guess, my last question is, Thomas, if I got the math down right, the selling at 20,000 per day is a little bit over 5 million shares a year. I think over the 60-year period, you'd be a young 130. So if you are doing this to manage estate and the other reasons

you noted at the beginning of the call, would you ever, at some point, entertain selling Interactive Brokers?

**Thomas Peterffy**

Rich, all I need to sell is enough to pay the tax when I die, right? Between now and when I die, I have to sign up to pay the tax at that time, right?

**Rich Repetto**

Alright. Okay. That's the goal of this selling?

**Thomas Peterffy**

That's right.

**Operator**

Our next question comes from the line of Craig Siegenthaler from Credit Suisse. Your question please?

**Craig Siegenthaler**

Could you provide us an update on your initiative to obtain a bank charter in the U.S.? And also, just remind us what products could come out of a bank charter besides cash sweep?

**Thomas Peterffy**

So the effort to get a bank charter got side tracked at the time when we had the SEC, FINRA, CFTC findings against us. And so we'll have to digest that and really prove that we have taken all the necessary steps, and the regulator should be very happy with everything we have done. And so that's probably going to take maybe 2 or 3 more quarters.

**Craig Siegenthaler**

Got it. And Thomas, I'm sorry if I missed it, but did you give us a start date for the 10b-5?

**Thomas Peterffy**

I think it's November 2<sup>nd</sup>.

**Craig Siegenthaler**

Got it, that's it for me, thanks for taking my questions.

**Operator**

Our next question comes from the line of Will Nance from Goldman Sachs. Your question please?

**Will Nance**

Good afternoon. So you're on track, I guess, to increase the account base by about 50%. And I know you aren't encouraging us to assume that this kind of continues at this rate, but just taking this massive acceleration of growth of the franchise at face value. Has this led to any evolution as your thinking...

**Thomas Peterffy**

Well, that would be wishful thinking. I don't actually think that it will continue at 50%. But it will continue at a, -- hopefully a fairly high rate.

**Will Nance**

Right. So even conservatively, though, the franchise has already expanded pretty considerably. So I guess when you think about the growth that you've already seen, has this changed any of your thoughts in terms of what types of products, customer-facing features, geographies, you need to be investing in or is it still kind of more of the same?

**Thomas Peterffy**

So it's more of the same in the sense that we are investing heavily in automation, more and more in automating customer engagement, watching -- having automated facilities that watch our customers and interact with them and watch what they are doing and interact with them and



telling them about the various options we have that they could find useful at the moment when they do whatever they are doing. That sort of automation. We are certainly going to continue to increase our marketing -- digital marketing expenditure around the world. And so we do hope that we can continue to grow at a very hefty rate, and we're going to invest whatever we can usefully spend in our view in further growth.

### **Will Nance**

Got it. That's helpful. And then just at a high level, activity rates are extremely high right now. And I guess, your customer base is more engaged than they have been in recent years. And so I guess, is there anything that's on your mind, I guess, other than the election that would make you think that maybe this comes to an end sooner than later? Or maybe conversely, what could kind of prolong these levels of activity? Does it really just come down to volatility? Or is there -- are you seeing like kind of different types of behavior for the customer base?

### **Thomas Peterffy**

Well, in the last couple of weeks, we do notice some moderation in activity, and -- which would be expected as we come up to the election. And then, of course, I think it will pick up when the results come out, especially if the Senate goes Democratic, I expect that people will start taking the long-term gains because of the expected 43% long-term capital gains tax rate. And then of course, we are looking further down the road, more and more spending that will result in asset inflation, including higher and higher stock prices. So that's not unique to Interactive Brokers. That's going to be just general. The financial services industry will have a fairly good time.

### **Will Nance**

Got it. That makes sense. And then just last question. I mean you have \$70 billion of client cash with a negative yield, and I think there are a lot of financial institutions out there that would salivate at having a funding profile that looks like that. When I look at how it's being monetized today, only roughly half of it is being monetized, funding margin loans. And there's still a fair amount that's earning 15 basis points, recognizing it's very difficult to monetize anything in this kind of interest rate environment. Do you spend a lot of time thinking about how to kind of

improve the economics on some of the client cash over time? And do you ever reach a point where you feel like there's some -- you need to kind of optimize that equation?

**Thomas Peterffy**

Well, we hope we keep trying to expand our margin lending, while we remain careful because we don't want to take on new risks. But -- so that's basically certainly a focus. We do not see any -- as you know, we are restricted in how we can invest our money. And we are certainly not looking at lower-grade, illiquid governments or long-term governments. That's not for us.

**Paul Brody**

So let me just add to that, if I could, Thomas. Will, you have to understand also that outside the U.S., it's not permitted regulatorily to use client credits to fund margin lending. They have to be kept separate. You segregate all of the credits and you finance the margin lending. And about 24% of our customer credits are outside the U.S. So what may appear to be a lesser use of our client balances, you have to take that into account.

**Will Nance**

Got it, that's helpful color. And good luck with continuing the 50% account growth.

**Operator**

Our next question comes from the line of Kyle Voigt from KBW. Your question please?

**Kyle Voigt**

I believe several years ago, Interactive Brokers paid a special dividend ahead of potential changes to the capital gains tax rate. I'm just wondering if a special dividend will be on the table again, if both the Presidency and the Senate go to Democrats, as you mentioned earlier.

**Thomas Peterffy**

I haven't thought of special dividends.

**Kyle Voigt**

Okay. Just in terms of maybe following up on the special dividend question. You still have well over \$6 billion of excess regulatory capital. And I know not all of that is pure excess, and you stated in the past that much of that is there to support your credit rating and the prime brokerage business as well and growth there. Just wondering if you could frame -- I mean, how much of that is really excess on the balance sheet? In other words, how much do you need to maintain the current credit rating and to continue to grow the prime brokerage business at these rates?

**Thomas Peterffy**

Paul, this is a question for you.

**Paul Brody**

Sure. I can respond. So maintaining the \$6 billion or so in excess regulatory capital is good, prudent management that really allows us to be flexible when the market gets extremely active or when institutional clients come to us for financing opportunities. It allows us to use that without bumping into regulatory constraints. Also, though, understand that a lot of our capital is, in fact, already devoted to supporting the client activity; it's spread out across many different countries and sectors. Some of it helps finance margin lending that takes place outside the U.S., as I just alluded to before. So our excess at any one time is really more like between \$2 billion and \$3 billion, let's say, to then take on new opportunities and the new opportunities do come. They come with regularity enough that we don't want to cut down that number. We actually make use of that capital.

**Kyle Voigt**

Got it, that's helpful, thanks Paul. Another question on just the large transaction that's happened in the space and closed in the space recently. I guess I'm curious to hear more about the potential opportunities that this presents you, both in the RIA segment and the active traders segment. And I guess I'm wondering if you can comment on whether you've seen any kind of over the past -- since the announcement to the deal close, if you've seen any influx in the in-bound calls or account openings potentially tied to that transaction specifically?

**Thomas Peterffy**

I'm sorry, you were breaking up. I couldn't hear the question. Paul, did you hear?

**Kyle Voigt**

Sorry, Thomas. I'm really asking about whether or not the Ameritrade-Schwab merger is creating opportunities for your RIA segment? Are you getting more in-bound customer calls?

**Thomas Peterffy**

Well, definitely. We definitely have lots of RIAs that come to kick the tires. They basically want to know that if they wanted to leave, would this be a good place to come to. So for now, it's a lot of work for us with not much business. But maybe, maybe it will materialize. You never know. So we spend a lot of time with these RIAs and then they go away and they say, "Oh, yes, this is very, very good to know. Thank you very much. Maybe we'll come back." And then that's the last we see them.

**Kyle Voigt**

Are you seeing any of that on the active trader side, Thomas?

**Thomas Peterffy**

I would not -- we wouldn't know that. We wouldn't -- no, I don't think so. No. I think most -- I mean most sophisticated active traders are already with us, I would think.

**Kyle Voigt**

Thanks Thomas, I appreciate it.

**Operator**

Our next question comes from the line of Chris Harris from Wells Fargo. Your question please?

**Chris Harris**

Great. So first question relates to trading activity. When we speak to investors about the space, about your business. There's really, I guess, 2 narratives that have kind of developed. One is that the trading activity you're seeing today is unsustainable and how volumes have to go down. And the other argument says that, no, no, we're in a new paradigm with 0 commissions and kind of a work from home environment and that this trading is sustainable. Do you have a thought on that, Thomas, one way or the other? Or whether maybe you would just disagree with both those things?

**Thomas Peterffy**

I think it is not sustainable at these levels, but it will certainly not go back to the levels of early in the year. So I think it will probably end up middle of somewhere, about halfway in between. That's what I would expect.

**Chris Harris**

Okay. Great. And I noticed that -- is the AML issue resolved? I didn't see it called out in the press release. So I'm assuming that means, yes, but just wanted to make sure.

**Thomas Peterffy**

The AML issue was certainly resolved. We have undertaken a lot of work that we currently have to get done. And that we will get done by the end of the year, which is much earlier than what we agreed to do. But -- so the answer is that the issue is resolved. The work is not finished yet, but it will be by early next year.

**Chris Harris**

Okay. And what additional work still needs to be done? Is it just related to the infrastructure?

**Thomas Peterffy**

Yes, it's basically software and the consultants. We have a number of consultants who have imposed various would be nice to have ideas and some of which we have accepted, and we're working on getting them done.

**Chris Allen**

Got it, thank you.

**Operator**

Our next question comes from the line of Chris Allen from Compass Point. Your question please?

**Chris Allen**

Good evening guys. I wanted to circle back on margin lending. You had noted earlier that you're gradually increasing requirements as we head into the election, and also the margin lending balances can fluctuate. I was wondering maybe you could give us an update in terms of where

they stand currently versus the quarter end number, which I think was \$30.3 billion.

**Thomas Peterffy**

So we are currently in the process of increasing margin rates. And I think that will -- and I think by the end of this week. Paul, is that correct?

**Paul Brody**

Yes, I believe that is correct. But let's remember that, by and large, these increases do not impact stock margin rates. They are focused on derivatives where the margin rates were lower to begin with. So as a result, since borrowing takes place against stocks, I wouldn't see a major impact there at all.

**Thomas Peterffy**

So our margin loans are gradually increasing as we speak in spite of the increase in the margin requirements.

**Chris Allen**

Got it. And then just a quick one on -- so the outlook for net interest income, reinvestment pressures, it seems like it's over on the seg cash side and rates have mostly stabilized. So -- and obviously, you just talked about margin lending. Sec lending, how do you feel about that moving forward? Has the sec lending box continued to increase? Do you still feel good about the outlook there?

**Paul Brody**

Oh, sure. I mean, mainly, and as I always say, it's opportunity-driven. Our base expands as our customer holdings and shorts expand. But the bigger your base, the more we can take advantage of specials, meaning stocks that get hot and in short supply, when they happen. And we've

developed a lot of software to recognize and try to optimize the rates at which we can capture those opportunities. So you will see it go up and down, perhaps because we're not in control of which stocks become special, but we do make the most of it when they exhibit that behavior.

**Chris Allen**

That's it for me, thank you.

**Operator**

And we have a follow-up from the line of Kyle Voigt from KBW. Your question please?

**Kyle Voigt**

Sorry. Just a follow-up for Paul, if I could, on the Other Fees and Services. I think that's increased \$5 million sequentially and \$10 million year-over-year. I'm just wondering if there's anything one-off to call out in there? Or is that just a result of just overall rapid growth in accounts? And is that sustainable, I guess, is the core of the question.

**Paul Brody**

It comes from a number of factors. One of the larger ones is market data, which is very much in line with the expansion of the customer base because we contract for a lot of market data and pass it on at a relatively small markup, but that number does expand. And really, the only other mentionable factor is, as I talked about before, we facilitate IPO participation by our customers. And that has been on the increase lately. So it has generated more fees than before.

**Kyle Voigt**

Got it, thank you.

**Operator**

Thank you. And this does conclude the question-and-answer session of today's program. I'd like to hand the program back to Nancy Stuebe for any further remarks.



**Nancy Stuebe**

Thank you, everyone, for participating today. As a reminder, this call will be available for replay on our website, and we'll be putting up a clean version of our transcript on the site tomorrow. Thank you again, and we'll talk to you next quarter end.

**Operator**

Thank you, ladies and gentlemen, for your participation in today's conference. This does conclude the program. You may now disconnect. Good day.