

Interactive Brokers Group's (IBKR)

Q4 2017 Results - Earnings Call Transcript

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Executives

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Paul J. Brody - CFO

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Rich Repetto *Sandler O'Neill*

Operator

Good day, ladies and gentlemen, and welcome to the Interactive Brokers Group Fourth Quarter Financial Results Conference Call. (Operator Instructions) As a reminder, today's conference is being recorded.

I'd now like to introduce your host for today's conference, Ms. Nancy Stuebe, Director of Investor Relations. Ma'am, please go ahead.

Nancy Stuebe

Thank you, operator, and welcome, everyone, to our fourth 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 in our press release. You should also review a description of risk factors contained in our financial report filed with the SEC.

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

Thomas Peterffy

Thank you for joining us for our final 2017 earnings conference call. In 2017, we got out of the old - by transferring the bulk of our Market Making business to a new owner - and into the new, introducing many new products and initiatives from the Interactive Brokers new debit MasterCard to trading in Bitcoin futures on the first day they began.

This past year marked our 40th year in the business and also marked 10 years since our initial public offering. To give you a sense of our growth over those 10 years, at the time of our IPO in 2007, Interactive Brokers had \$2.8 billion in total equity. The electronic broker had about 80,000 customers, \$7 billion in customer equity and \$2 billion in margin loans outstanding. Our customers could trade on about 50 exchanges and market centers in 16 countries.

As of December 31, 2017, we had \$6.4 billion in total equity. That is after having distributed another \$3.8 billion in dividends. Our customers can trade on over 120 exchanges and market centers in 26 countries. We have 483,000 customer accounts, up 6x; \$124.8 billion in customer equity, up 18x; and \$29.5 billion in margin loans, up 14x. Versus 2016, these numbers are up 25%, 46% and 52%, respectively.

One thing has clearly not changed during the past 10 years, and that is our rapid growth. If anything, we have seen growth rates accelerate. This accelerating growth is the key to our story.

To illustrate, I compare our growth to 2017 from 2016. Number of accounts were up 16% in 2016 and up 25% in 2017. Client equity was up 27% in 2016 and up 46% in 2017. Margin loans were up 14% in 2016 and up 52% in 2017.

Can we keep growing at these rates or possibly even accelerate further in 2018? That is the big question for this year. We will do all we can, and we know that you will be watching and impatiently waiting for our press releases at noon of the first business day of each month that describes our business metrics for the past month.

But for now, just 16 days into the new year, whatever favorable trends we can see ahead of us may be more wishful thinking than actual data. Our hope is that we become a larger -- as we become a larger company, more people will see and hear about the new technology and cost advantages of our platform. I describe this in a 4-minute video you can watch posted on the homepage of our website. If you watch it, you will learn what is driving our growth and bringing customers to our platform.

Our reported pretax income for the quarter was \$364 million and for the full year, \$1.05 billion. Excluding impacts from the new tax law, the winding down of our market maker and other noncore items, these numbers were still very strong with pretax income of \$274 million for the quarter and \$872 million for the year. This improvement occurred despite the fact that 2017 began the same way 2016 ended, as an unusually slow period for the markets.

We saw very low, in fact, historically low volatility. While we did begin to see a pickup in activity as the year went on, with the fourth quarter being closer to what I would consider normal trading activity, 2017 closed out again with low volatility. The fourth quarter average VIX was 10.29, down 6% from the third quarter and down 27% from last year. Our customers continue to trade despite this. Any pickup in that measure, like we saw in the third quarter, would produce an even stronger trading level from here.

Our fourth quarter net revenues rose to \$515 million in 2017 from \$193 million in 2016. Commissions were \$170 million, up 13%, while our net interest revenue was \$204 million, up

48%. We transferred most of our Market Making business to Two Sigma Securities at the end of the third quarter. So for the first time in the fourth quarter, our business is now predominantly the electronic broker.

Because of the recent tax law's reduction in the U.S. corporate tax rate, we will be paying less U.S. taxes going forward, but must write down our deferred tax asset now. In addition, we must pay tax on a portion of accumulated income abroad that has not yet been taxed in the U.S. The effect of this on our income is an \$84 million charge.

So for your models, our other income this year would have been \$37 million; net revenues, \$425 million; pretax income, \$274 million; and income taxes, \$23 million without the tax law change and a few other items Paul will have more details on. As a result of our relentless organic growth, brokerage equity capital reached \$4.9 billion in 2017 and brokerage profit of \$252 million was the highest in our history to date.

The increase in brokerage profits was mostly driven by higher interest income, which was up 51%, thanks to increased assets, margin loans and, to a lesser extent, higher average benchmark rates. Our customers' margin balances and credit balances moved higher, with margin loans reaching a period end high of nearly \$30 billion as our customers capitalized on year-end trading opportunities and our low margin rates.

Excess cash from our customers' credit balances are invested primarily in reverse repos and short to medium-term Treasury securities. This has provided a continuing stream of higher interest income as our clients' balances grew. We are always looking for ways to improve what we earn on these balances, so we started an insured bank deposit sweep program, which our customers have shown interest in, and we continue to look at investing in agency securities though we did not have any of these at the end of the year.

Because Interactive Brokers believes in giving investors the greatest opportunities to succeed, in addition to the most powerful technology, we have and we will continue to pass through to our clients any future increases in interest rates. The rates we pay to our customers are indexed to the

benchmarks. Accounts with over \$100,000 of value in the U.S. receive interest on their cash holdings of 92 basis points, all but half of 1% of the benchmark Fed funds rate. Most competitors we know of pay practically nothing on excess overnight cash in brokerage accounts. They pocket your interest. We do not. That is an Interactive Brokers benefit that increases our customers' returns and profits, which is extremely important to us.

In our brokerage business, we saw growth in all 5 of the client types that we service. I will now go over our 5 client segments.

We saw particular strength again in our introducing broker segment, which had 2017 account growth of 61%, up from 33% growth last year; and client equity growth of 94%, up from 53% last year. As the operating and especially the regulatory cost of running the brokerage firm continued to increase, smaller and midsized brokers who find it difficult to justify maintaining their own technology come to us to white-brand our state-of-the-art technology and capitalize on our lower costs.

A broker who wants to be up and running right away with powerful technology and little back-office hassle can come to Interactive Brokers and be in business in a matter of a couple of weeks, if not days. Because of our automation, our costs are very low and we charge very little, making it much less expensive for a broker to come to our turnkey system than to maintain its own.

The benefit to the broker is that they are charged our lowest commission rates, which they can mark up. The benefit to us is that many of these accounts are below IBKR's \$100,000 threshold for interest payment, and we can therefore capture that revenue while providing the lowest commissions and best execution.

The introducing broker provides the customer service for, and manages the relationship with, his client. We provide the rest: the trading, reporting, clearing, custody and regulatory tasks. This symbiotic relationship works well for both sides, and we have captured a tiny fraction of what we believe is a huge market and still have much more room to grow here.

Again, we saw good growth in the hedge fund customer segment. This group is 1% of our

accounts, 10% of our client equity and 9% of our commissions. For the year, we saw 18% growth in hedge fund accounts, 55% customer equity growth and commission growth of 6%. Big banks in both the U.S. and overseas continue to worry more about preserving their balance sheets than keeping their customers, so they ask small and medium-sized hedge fund clients to leave. This encourages more potential hedge fund clients to try Interactive Brokers, see the quality of our platform and the strength of our balance sheet. Hedge funds are a large, multitrillion-dollar global market, and we have tremendous room to grow in this area.

Individual customers, which make up 52% of our accounts, 36% of our client equity and 49% of our commissions, saw account growth of 15% for the year while client equity grew 43% and commissions grew 2%. The slow trading environment meant that commissions for these customers didn't grow as much as we would have liked. We have opportunities to grow our customer base in this segment using our new products and our compelling commission, interest and margin rates.

Proprietary trading firms are 3% of our accounts, 10% of our client equity and 17% of commissions. For the year, this group grew 9% in accounts, 17% in customer equity and 4% in commissions. I believe we are well penetrated in this segment. So while we expect it to grow, it will not represent our largest customer development opportunity.

Our final category is financial advisers. They are 19% of our accounts, 24% of our customer equity and 17% of our commissions. This group grew accounts by 19%, customer equity by 34% and commissions by 4%. Last year, we focused on making it as seamless as possible for registered financial advisers to achieve their independence, launching Greenwich Compliance, which provides registration and compliance assistance for new or existing RIA businesses. Going independent means RIAs can keep all the fees they earn. In an environment where most advisers are looking to become independent, our low commission and financing rates, and the Greenwich Compliance services, have all contributed to driving growth in this segment.

New products, like the introduction of the Interactive Brokers Debit MasterCard, also benefited this segment. Now RIAs can do everything for their customers from one account: invest, save,

pay bills and borrow. Globally, investment advisers have about \$25 trillion in AUM, the largest market segment we are in. So we have plenty of opportunities in this area.

We look forward to the upcoming quarters. We are dedicated to continually introducing new capabilities and improving the power, control, security and customization of our platform for our customers. If you are not already a customer, try our free demo, investigate our new Order Management System, try out our sophisticated algorithm - which you can customize to suit any trading strategy you can think of. As I said before, the key to our story is continuing rapid growth across all of our customer segments.

The overwhelming majority of our new customers come to us by recommendation of existing customers. The more we do for our customers to have a successful experience, the more likely they will be to enthusiastically recommend our platform to their friends and neighbors. Therefore, our growth strategy remains the same: continue focusing on building technology in order to maintain our low cost to secure the best possible transaction prices, to enhance our services, provide more products, trading and research and account management tools to attract more customers. The more new customers we onboard tomorrow, the more customers they will bring to us in the following weeks and months. The runway in front of us continues to be practically unlimited.

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

Paul Brody

Thank you, Thomas, and thanks, everyone, for joining the call. We have much to review, so I'll jump right in.

The fourth quarter operating results showed a solid performance in brokerage, led by stronger commissions and gains in net interest income. As we previously announced, the bulk of our Market Making business was transferred to Two Sigma Securities at the end of the third quarter, so Market Making represented a small portion of overall results.

Full year results reflected the increasing strength and operational leverage of core brokerage and the winding down of Market Making. Our pretax income of \$1.05 billion represented a profit margin of 62%. Excluding the net impact of noncore items, such as the new tax law, market maker exit costs, currency translation effects and Treasury marks, our pretax income was \$872 million, with a pretax margin of 58%.

Overall, operating metrics reflected improved customer trading even as the market volatility remains low. While the market volatility remained muted, we saw an increase in customer trading activity, especially in the third and fourth quarters, with quarterly total DARTs up 14% from last year. Average overall daily trade volume for the quarter was 1.27 million trades per day, down 3% from the fourth quarter of 2016, which reflected the drop in Market Making volume, and up 4% sequentially.

We continue to see strength this quarter in number of accounts, asset gathering and margin balances in brokerage, as I'll describe in my comments on the segment's performance. Electronic Brokerage metrics showed solid increases in the number of customer accounts and customer equity, up 25% and 46%, respectively. Total and cleared customer DARTs were up 14% and 15%, respectively, from the year-ago quarter even in the face of that low volatility. Market Making contract and share volumes were, of course, down across product types as we wound down this business.

Fourth quarter net revenues rose 167% versus last year and higher pretax income led to a pretax margin of 71%. These increases were largely driven by noncore items. Excluding the impact of the new tax law, market maker exit costs, currency translation effects and Treasury marks, net revenues were up 19% versus last year, while pretax income was up 43% for a pretax margin of 64%.

While the Market Making business is being wound down, Electronic Brokerage results were boosted by strong gains in customer accounts and equity, along with strength in our interest-earning assets. Other market factors had the following impacts:

Notably, the change in U.S. tax law. The Tax Cuts and Jobs Act tax legislation lowered our corporate income tax rate, and also imposed a onetime transition tax on deemed repatriated earnings at some of our foreign subsidiaries. This resulted in a net reduction in our consolidated earnings of approximately \$84 million or \$0.45 per share. Nearly 3/4 of this is due to the onetime repatriation tax, which must be recognized in our financials immediately, but will be paid out over an 8-year period. The remainder is related to the remeasurement of deferred tax assets at lower enacted corporate tax rates, and I'll go into more detail on this point later.

Low market volatility continued. The average VIX fell 27% year-over-year and 2017 saw VIX levels that were routinely the lowest since 1993. Actual-to-implied volatility fell 12% from the prior year quarter. Our increased customer activity in the face of historically low VIX levels gives us reason to believe that we are well positioned to benefit from even a slight uptick in volatility and the resultant volume that it generally brings.

Next, the U.S. dollar weakened slightly in the fourth quarter versus other major currencies. As a result, the currency basket in which we keep our equity, which we call the GLOBAL, rose 0.1% against the dollar for the quarter. This resulted in a modest gain of \$5 million, which includes the gain of \$6 million reported in Other Income and a loss of \$1 million in Other Comprehensive Income or OCI. We estimate the total impact to earnings per share from the GLOBAL to be a gain of \$0.01 for the quarter, reflected primarily in Other Income.

For the full year, the U.S. dollar weakened 3.1% relative to other major currencies, resulting in a gain of \$175 million, which includes the gain of \$110 million reported in other income and the gain of \$65 million in OCI. We estimate the total impact to full year earnings per share from the GLOBAL to be a gain of \$0.33, with \$0.18 reported as Other Income and \$0.15 as OCI.

Short- to medium-term interest rates rose again in the quarter, as the Federal Reserve continued to raise its target rate with another 25-basis-point increase. Market reaction to forward interest rate expectations has been stronger, and despite our short duration portfolio, which we manage to reduce our yield curve exposure, we recorded a mark-to-market loss of \$9 million in our Treasury

portfolio. Although we plan to hold these securities to maturity, we must, as brokers, unlike banks, mark them to market quarterly. We continue to hold a relatively short duration portfolio in order to reduce our yield curve exposure.

Net revenues were \$515 million for the quarter, up 167% on a reported basis from the year-ago quarter. And comparing this quarter's revenues to the prior years, the impact of the new tax legislation increased Other Income, a component of revenues, by \$93 million. This gain was more than offset by additional tax expense.

Treasury portfolio marks-to-market were a loss of \$9 million compared to a loss of \$11 million in the year-ago quarter. Currency gains added \$6 million to our revenues compared to a loss of \$152 million in the year-ago quarter. Adjusting for these items on a pro forma basis, Other Income was \$37 million and our total net revenues for the fourth quarter were \$425 million versus \$356 million in the year-ago quarter, an increase of 19%. This core increase was driven primarily by continued strength in our Electronic Brokerage segment, somewhat offset by the winding down of our Market Making business.

For the fourth quarter, commissions and execution fees were \$170 million, up 13%. Net interest income was \$204 million, or 48%. Brokerage produced \$195 million and Market Making, \$9 million. As the most recent Federal Reserve rate hike took effect in mid-December, we expect most of the benefit of that increase to be reflected in our numbers going forward. Trading gains were \$14 million, down 64% from the year-ago quarter due to the winding down of our Market Making operations.

Other Income, which, as I described earlier, includes some of the effects of the new tax legislation as well as our currency diversification strategy and Treasury portfolio marks, was \$127 million versus a loss of \$134 million in the prior year quarter. Without the noncore items discussed above, Other Income would have been, as I said, \$37 million, up 28% from the year-ago quarter.

Noninterest expenses were \$151 million for the quarter, down 8% from the same quarter last

year. The decline reflects reductions related to the winding down of our market maker, partially offset by higher expenses in the growing brokerage business. We continue to closely manage our expenses as we selectively build our capabilities in growth areas.

At December 31, 2017, our total headcount stood at 1,228, an increase of 2% over the prior year headcount and 2% sequentially. While several employees went with our Market Making business to Two Sigma Securities, we retained many developers and engineers for our growing brokerage business. And we continue to expand in a few key areas, notably, customer service and legal and compliance.

Our reported pretax income this quarter was \$364 million, leading to a 71% pretax margin. Excluding noncore items, our pretax income was \$274 million for a 64% pretax margin. This compares with fourth quarter 2016 adjusted pretax income of \$191 million for a 54% margin, net of the same factors.

Brokerage pretax profit margin was a reported 65% as compared to 57% last year. And adjusted for the noncore items, brokerage pretax profit margin was also 65% versus 59% in the prior year quarter.

Market Making pretax profit margin was 32% versus 27% last year.

For the full year 2017, we earned pretax income of \$1.05 billion on net revenues of \$1.7 billion, versus \$761 million on \$1.4 billion of net revenues in 2016. Excluding noncore items, our pretax income for the year was \$872 million for a 58% pretax margin. And this compares with full year 2016 adjusted pretax income of \$775 million for a 55% pretax margin on the same basis.

Comprehensive diluted earnings per share were a loss of \$0.02 for the quarter, as compared to a loss of \$0.05 for the quarter of 2016. On a noncomprehensive basis, which excludes OCI, diluted earnings per share on net income were also a loss of \$0.02 for the quarter as compared to earnings of \$0.07 for the same period in 2016. Excluding the impact of the noncore items, results in comprehensive diluted earnings per share of \$0.43 versus \$0.32 last year and

noncomprehensive diluted earnings per share also of \$0.43 for the current quarter versus \$0.32 for the year-ago quarter on the same basis.

The noncore items affected fourth quarter comprehensive earnings per share as follows: a decrease of \$0.45 for the new tax law; an increase of \$0.01 for the GLOBAL currency translation; and a decrease of \$0.01 for Treasury marks.

Looking at the full year of 2017, comprehensive diluted earnings per share were \$1.22 versus \$1.19 in 2016. On a noncomprehensive basis, which excludes OCI, diluted earnings per share on net income were \$1.07 versus \$1.25 in 2016. Excluding the impact of the noncore items, results in comprehensive diluted earnings per share of \$1.39 versus \$1.29 last year and noncomprehensive diluted earnings per share of also \$1.39 for the current year versus \$1.29 for the prior year on the same basis.

The noncore items affected full year 2017 comprehensive earnings per share as follows: a decrease of \$0.46 for the new tax law; an increase of \$0.33 for the GLOBAL currency translation; a decrease of \$0.02 for Treasury marks; and a decrease of \$0.02 from market maker net exit costs.

Now we turn our attention to taxes, so get your pencils out. To help investors better understand our earnings, I'd like to break out our pretax income so that you can see the split between the public shareholders and the noncontrolling interests.

The Tax Act had a onetime impact in a couple of areas this quarter. First, the deemed repatriation of earnings on some of our foreign subsidiaries results an additional tax of \$62 million - recognized in this quarter, but to be paid over 8 years.

Second, the remeasurement of deferred tax assets. Our corporate structure allows us to generate tax benefits for our public company which are shared with IBG Holdings LLC, which is known as the "noncontrolling interest" in our financial statements. The public company retains 15% of these benefits. On our balance sheet, the future benefits are recorded as a deferred tax asset. And

the noncontrolling interest's share is recorded as a liability. When the corporate income tax rate was reduced, we remeasured the value of these items and reduced both the asset and the corresponding liability. The asset was reduced by \$115 million, which is added to income tax expense. And the liability was reduced by \$93 million, which is added to other income. The net effect is a reduction of 15% of the benefit, but that is offset by lower tax rates going forward.

The onetime recording of additional tax from the remeasurement of deferred tax assets is a noncash item that affects our reported income only and not actual taxes paid.

Here's how all this is reflected in the income statement. Starting with income before income taxes of \$364 million, we deduct the \$93 million of other income because it is only related to the public company. This leaves \$271 million pretax income of our operating companies. We deduct regular income taxes of \$9 million, plus \$62 million for the deemed repatriation of foreign earnings. This leaves \$200 million net income at the operating company level, of which 82.6% or \$166 million is attributable to noncontrolling interests. The remaining 17.4% or \$34 million is available to public company stockholders. To this, we add back the \$93 million, giving us \$127 million of taxable income to the public company. We deduct our usual income taxes, which are \$14 million this quarter, plus another \$115 million for the deferred tax asset remeasurement. That leaves a \$2 million loss available to common stockholders.

The total income tax expense of \$200 million consists of \$9 million of tax and \$62 million of earnings repatriation tax at the operating company level, plus \$14 million of tax and \$115 million of deferred asset remeasurement tax at the public company level.

Finally, on the effect of the lower tax rate, we have estimated that had the new tax law been in place for 2017, our full year earnings per share would have increased by about \$0.25.

Turning to the balance sheet. It remains highly liquid with low leverage. 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. We are extremely well-capitalized from a regulatory standpoint, and we continue to deploy our equity capital in the growing brokerage business.

We elect to hold excess capital to take advantage of opportunities as well as to convey the strength and depth of our balance sheet. We continue to carry no long-term debt, and our consolidated equity capital at December 31, 2017, was \$6.4 billion, of which approximately \$4.9 billion was held in brokerage, \$1.3 billion in Market Making and the remainder in the Corporate segment. Capital made available from winding down Market Making operations will be made available to the broker, and that process has started and will continue through 2018.

Turning to the segments. With Electronic Brokerage this quarter, we saw a rise in stock volume, largely driven by increased trading in low-priced stocks in the U.S., Hong Kong and Australia versus the prior year quarter.

Customer trade volumes were higher in options and stocks and lower in futures versus strong U.S. election-related futures trading in 2016. While cleared customer DARTs rose 14% over the prior year quarter, cleared customer volume was mixed with options contract and stock share volumes rising 12% and 44%, respectively, while futures contracts fell 1% from the year-ago quarter and foreign exchange volume was off 5% from the year-ago quarter.

Commission revenue rose 13% on a product mix that featured smaller average trade sizes in options and futures and substantially larger in stocks. This mix resulted in an overall average cleared commission per DART of \$3.92 for the quarter, down 2% from the year-ago quarter. For the full year, commission revenues rose 6% to \$647 million. Customer equity grew \$124.8 billion, up 46% from last year and 8% sequentially. The source of this growth continues to be strong inflow of new accounts and customer assets as well as customer profits.

We continue to have success in attracting increasingly larger customers, including hedge funds as well as financial advisers and introducing brokers that while large overall, manage groups of smaller accounts. In particular, large introducing brokers, who bring their business to us on either an omnibus or fully disclosed basis, are signing up with greater frequency.

Our average account equity rose 16% year-on-year to \$258,000. In addition to the larger accounts

that we are attracting, part of this growth was fueled by new services to targeted customer types, including our new Interactive Brokers debit MasterCard, our new Order Management System and our strong mobile offerings.

Margin debits rose 52% year-over-year, reaching a record level of \$29.5 billion. Our compelling margin lending rates, especially in a rising interest rate environment, along with customers' appetite for increased risk and our expanded prime broker financing, were responsible for this increase. Customer credit balances continued their steady growth, rising 13% over the year-ago quarter.

Net interest income rose in the fourth quarter to \$195 million, up 51%, and our net interest margin widened to 1.44% from 1.10% from the fourth quarter of 2016.

For the full year, net interest income rose to \$649 million, up 30% from 2016 and represented 46% of net revenues as compared to 40% in the prior year. The Federal Reserve's 3 rate increases in the U.S. Federal Funds target rate in March, June and December, together with increased customer balances, have generated more net interest income. While we expect further contributions from interest-sensitive assets going forward, our policy of giving our customers the benefit of future rate increases will necessarily limit our upside here.

Our multibank FDIC sweep program began in the fourth quarter. And while we're seeing positive results, it's still early days, and we'll have more detail on this in the quarters ahead.

With a growing customer asset base, we continue to believe we're well positioned to prudently maximize our net interest income given the opportunities presented by the market. Based on current balances, we estimate that a general rise in overnight interest rates of another 25 basis points would produce an additional \$11 million in net interest income over the immediately following 4 quarters and \$15 million as a yearly run rate. Holding our balance sheet constant, further increases in rates would have a smaller impact because the interest we pay to our customers is pegged to benchmark rates less a narrow spread.

Execution and clearing expenses were \$52 million, up 13% year-over-year and in line with volume increases. Fixed expenses in brokerage were \$86 million, up 8% over the year-ago quarter and down 1% sequentially. The primary component of the annual increase was higher G&A expense, as we absorbed further software development resources from Market Making and also legal and regulatory costs.

Customer bad debt expense was negligible in the fourth quarter. Our Risk Committee continues to enhance our scenario-based risk models in order to reduce exposures to world events.

Pretax income from Electronic Brokerage was \$252 million, up 50% from the prior year quarter, for a 65% pretax margin. Excluding Treasury marks, core pretax income was \$261 million, up 46% from the prior year quarter on the same basis.

And for the full year 2017, pretax income from Electronic Brokerage was \$860 million, up 14% from the prior year for a 61% pretax margin. Excluding Treasury marks, core pretax income for the year was \$872 million, up 19% from the prior year on the same basis.

In Market Making, we closed on the sale of our U.S. options Market Making business to Two Sigma Securities at the end of the third quarter. As a reminder, we announced our intention to wind down or sell this business last March, and began to pull back in this area, and our results reflect this. The continuing low level of market maker activity reflects certain profitable ongoing foreign operations, which may continue for some time.

As we noted in our previous call, we have the opportunity for future income from an earn-out agreement, based on how well the options Market Making business performs under Two Sigma's control. Under the agreement, we would earn a share of any U.S. profits after variable costs and agreed upon other costs, for 3 years and a separate share of any non-U.S. profits, after variable costs, for 4 years. The agreement with Two Sigma Securities provides them the opportunity to enter non-U.S. parts of this business. And while it does not preclude us from participating in those markets, the earn-out would be effective only in markets where we do not compete.

Trading gains for Market Making for the fourth quarter were \$14 million, down 64% from the year-ago quarter. Given the winding down of this business as well as the impact of low market volatility, this was expected. We continue to operate in some profitable foreign markets.

Pretax income was \$8 million for the quarter, down from \$12 million last year. And for the full year, we had a pretax loss of \$27 million versus income of \$44 million last year, primarily due to write downs in the value of this business around its transfer to Two Sigma Securities.

And on the cost side, execution and clearing fees expenses were down 71% in line with lower trading volumes. And fixed expenses decreased to \$13 million, down 32% from the year-ago quarter.

Just a few more notes on the market maker wind down. We recognized less than \$1 million in compensation expense due to onetime severance costs this quarter. As we had estimated earlier this year, this represented approximately the remainder of the \$25 million in onetime market maker wind-down expenses.

We expect that the continuation of certain market maker operations outside the U.S. for some period of time will significantly defray these onetime costs, and these results are and will continue to be reported in the Market Making segment quarterly.

Our brokerage operations will absorb about \$40 million of expenses annually or about \$0.08 in earnings per share. The added costs consist primarily of personnel and certain technology infrastructure. As we have said, we expect our brokerage business to benefit from the additional software development resources, and the personnel transfers will contribute to the slowdown in outside hiring, as we are seeing in our headcount numbers, for some period of time.

For the fourth quarter, about \$5 million in employee compensation and technical costs were absorbed in brokerage in addition to the \$5.5 million over the second and third quarters. On a run rate basis, the brokerage business has now absorbed approximately 82% of that \$40 million annual amount, and we expect the migration of these expenses to continue over the coming

quarters until the full amount is absorbed sometime in 2018.

A few words on the Corporate segment. The earnings reported there reflect effects of our currency diversification strategy. Our overall equity as measured in U.S. dollars was increased by the weakening of the U.S. dollar against all other major currencies. We estimate the overall gain from our strategy of carrying our equity in proportion to the GLOBAL to be about \$5 million for the fourth quarter of 2017. As I described, because \$1 million of this is a loss reported as Other Comprehensive Income, this leaves a gain of \$6 million to be included in reported earnings.

And for the full year, the overall gain from our strategy of carrying our equity in proportion to the GLOBAL was \$175 million, with \$65 million reported as OCI, leaving \$110 million to be included in the reported earnings.

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

Question-and-Answer Session

Operator

(Operator Instructions) Our first question comes from the line of Rich Repetto with Sandler O'Neill.

Rich Repetto

I guess the first question is the strong margin loan balance growth. This quarter, just quarter-to-quarter, it was up \$4.4 billion. It was the strongest quarter-over-quarter sequential quarter growth. And I'm just trying to see -- get a little understanding of a little bit what's driving that. And you talk about the increased trading over in Asia, the pickup. But what made it grow faster than it ever had -- at least by dollar amount -- than it has prior?

Thomas Peterffy

Well, what is driving it is the extremely low margin rates that we charge. So that is part of the reason that towards the end of the quarter, we have -- or was it even after the end of the quarter?

Yes. As of the 22nd of January, we are increasing our margin rates for the very highest borrowers by 5 basis points in order to slow that growth.

Paul Brody

If I could just add to that comments then, Thomas and Rich. There is a portion of the financing that professional hedge funds like to take advantage of when they see market rate opportunities. And so a portion of that strong increase comes from high-end professionals. And it's not the majority of it by any means, but might be 1/4 of it.

Rich Repetto

And would you consider that, how do I call it, sustainable when institutions like hedge funds increase their borrowings?

Paul Brody

They do it opportunistically. So it may not be on all the time. But it certainly -- it comes on and off frequently enough that it's become more of a regular part of our business.

Thomas Peterffy

Rich, this is -- this has to do with -- there are certain risk-free opportunities in the market right now as far as the option boxes and single stock futures and rates, and some of our customers are taking advantage of that.

Rich Repetto

Thomas, you're going to need to tell me those risk-free opportunities like that. But anyway, I'm not a trader. The follow-up question would be for Paul. On the taxes, you said that if you -- at current -- with tax reform, that it would have increased your EPS by \$0.25. I'm just trying to walk through the mechanics so -- to understand how you get there, if it's possible.

Paul Brody

It's not possible in a short conversation. The tax computation itself, as you know, is fairly complex. What we did though was rather than try to provide some forward guidance, we thought

that the best measure would be, what if we just ran 2017 through a new tax model as if it had operated under the new tax law. So it doesn't include any of the onetime effects. It includes what 2017 would have looked like as a normal year. But I can tell you that, obviously, there's a benefit from the lower tax rate, but somewhat offsetting that are certain deductions and tax credits that are no longer eligible. So it's not quite a full capture of -- from 35% rate down to 21% rate. I can tell you that we estimated that in that -- in estimating for 2017, whereas our -- roughly our effective income tax rate on the corporate level had been about 36.5% previously, that went to about 22.5%, 22.6% effective for 2017 under the new law. So in other words, a little bit higher than the federal rate.

Rich Repetto

Yes. And then one last quick one, Paul. You said that out of the \$40 million, I think you said 82%. So it sounds like there's still \$8 million or somewhere around there to go. So I guess what you're implying is, on a quarterly basis, expense -- you could absorb another couple of million per quarter. Is that -- am I interpreting correctly -- from Market Making to brokerage?

Paul Brody

Yes, well -- yes, I'd like to be clear on that point and not confuse the expenses that have already been absorbed with what we put out as the run rate because I thought that, that is a number that makes sense for modeling going forward. So we're roughly at 82% going forward.

Rich Repetto

So incrementally a couple of million?

Paul Brody

Incrementally, 82% of the \$40 million should be now absorbed into brokerage. Of course, the full amount wasn't absorbed during 2017 because it was done in pieces and sequentially.

Rich Repetto

But 82% is in the fourth quarter run rate, is that fair to say?

Paul Brody

No, it's a December 31 point in time going forward because we migrated resources during the year and during the quarter, and so only part of the expenses were actually absorbed. But going forward, we are at a run rate now of just about 82%, and that will continue throughout 2018, that should eventually go to 100%.

Operator

(Operator Instructions) Our next question comes from the line of Conor Fitzgerald, Goldman Sachs.

Conor Fitzgerald

Maybe just a follow-up on Rich's question. You're talking about gaining share in margin loans. Can you give us any color in terms of either transfer of accounts or transferring of funds what customer segment you're getting the most share in or perhaps where geography-wise you're taking the share from?

Thomas Peterffy

Most of the margin loan increases are from U.S. customers.

Conor Fitzgerald

That's helpful. And then just on deposit cost, how to think about that next quarter. Can you give us a sense of where the 36 basis points you paid out for customer credits should migrate post the Fed hike in December?

Thomas Peterffy

Paul?

Paul Brody

Yes, that's a multipart question. Well, so conceptually, what we do is for all balances that are eligible to earn interest, they will step up with the Fed funds rate, at least the U.S. dollar ones will, which is the majority. So that's why we say going forward, we don't -- on a given dollar

value of those deposits, we won't earn more because whatever we earn more will be passed through to our customers. Where we do earn more is on smaller balances where we're not paying interest. And obviously, we capture all of the higher rate there. And then, of course, in all the foreign currencies, they don't march to the beat of the same drummer. And just because the Fed is moving around doesn't mean they are. So when we estimate currently in our model for interest rate sensitivity, when we estimate a 25-basis-point increase, it's only for the U.S. dollar amount.

Operator

Our next question comes from the line of Mac Sykes with Gabelli.

Mac Sykes

Thomas, just given your comments about the progress from the IPO and your platform has been pretty much the leader in technology for the industry. I guess, at this point, how much more innovation can we expect? And should we expect the bulk of sort of capital spending to support the overall platform? Or should we expect more engagement tools, products, et cetera? Maybe you could just bucket sort of the kind of the percentages or some qualitative aspect to where you see the industry and your platform going.

Thomas Peterffy

Well, the innovation -- opportunity for innovation, in my view, is infinite. And we are going to do as much of it as we are able to hire and manage developers. And that is -- hiring is difficult and management is difficult. It is. But nevertheless, we are -- we expect to spend -- we expect our spending to increase in line roughly with -- in line with our growth. I hope we can spend as much money as we grow.

Mac Sykes

Just my follow-up. You discussed your customer segments, but have there been any changes in terms of your progress in terms of geography? Any of note over the last year in terms of doing better or worse?

Thomas Peterffy

Well, yes. I mean, the highest growth basically is happening in China, Brazil, Hong Kong, Russia. These are roughly the places where our growth rate is very high other than countries where we have just few customers and then an addition of a few number represents a very high growth rate. But the bulk of the higher growth in new customers are coming from the Far East and South America.

Operator

Our next question comes from the line of Christopher Allen with Rosenblatt.

Chris Allen

Just a couple of questions within NII. I just wonder if you could provide any color on the sequential increase in yields in seg cash. I'm guessing just higher short-term rates helping there. And then maybe some more color just in securities borrowing, the revenues there. You had some really nice growth over the course of the year. Are you seeing additional uptick -- uptake there or is it any specific securities driving outsized activity? Just trying to think about the go-forward path there.

Thomas Peterffy

Paul?

Paul Brody

Yes. So yes, on the seg cash investments, they float with the market rates. We're fairly limited in what we can invest in. As Thomas said, we're primarily in reverse repo of Treasuries and some Treasuries themselves. And that's why we're spreading to earn some additional yield on things like the insured bank deposit program which is still quite small. So we'll be reporting more of that in the future. Chris, what was your second question?

Chris Allen

Yes, just the securities borrowing and lending activity. You've seen really nice growth in the revenue side. Obviously, when we look -- kind of look at the balances there, that's always a little bit murky to kind of look at because it's volatile. Just wondering like what's the kind of key

drivers, seeing more uptake of your product which we know is a pretty attractive product or is it just hot activity in certain stocks or...

Paul Brody

It's actually both of those things. So there's a growing base as we become more well-known as a place to go to if you want to short stocks because we have very good availability on covering those. In fact, more and more so it grows upon itself because we're able to satisfy customers who want to short securities with customer stock who -- stock that's being held on margin. And also, we have a fully paid program called our Stock Yield Enhancement Program so that if you're holding fully paid shares, you can lend those as well and earn back half of the -- generally, half of the value of what they're being lent for. But your other point is equally true, which is that it's an opportunistic business so that if our customers tend to buy shares of stocks that are hot or are hard to borrow in the borrowing market, then it's simply much more profitable to lend those out. And over time, we've built a lot of tools to help us maximize that -- those earnings -- by acting quickly and by managing the inventory in an optimal way.

Operator

Our next question comes from the line of Chris Harris with Wells Fargo.

Chris Harris

Yes, on the tax reform, should we be expecting most of the benefit of that to flow through 100% to your bottom line? And then a related question, how are you thinking about your regular dividend payment in light of the lower tax rate now?

Thomas Peterffy

As far as the dividend payment is concerned, we are going to sit tight. The dividend will be unchanged. As far as the taxes, as Paul explained just before, it's not a direct drop from 35% to 21% in our case because there are certain items, like the Tax Receivable Agreement. So we didn't pay the full 35% and therefore, it's not -- the benefit is not the entire thing. Paul, would you have an estimate as to what percent of the 14% tax savings actually will pass through to...

Paul Brody

Right. So that's what I -- well, what I indicated before was that our effective corporate tax rate on the portion flowing through will be about 22.6%. So in other words, we pay state taxes and so forth. And so it's very similar to previously when there's a 35% federal rate, our effective rate was about 36.5%, including the states and so forth. Now with the 21% rate, it will be up around 22.6%. That's our current estimate. And that's an estimate.

Chris Harris

Because I was thinking more of the strategic decisions like whether or not you guys are going to alter your pricing given the lower tax rate, whether you're going to increase your spending, things of that nature. Maybe just conceptually, we don't take it into...

Thomas Peterffy

We're not sensitive that way to the tax.

Operator

Our next question comes from the line of Doug Mewhirter with SunTrust.

Doug Mewhirter

First question was more of a conceptual question on taxes. And I think it's more of a question of the actual wording of the policy. So I assume that there's -- you're still taxed at U.S. rates globally regardless of the local tax rate. Is that why you're -- it's sort of a relatively linear drop to the effective tax rate? So there's no complexities of different tax rates in China or India or Europe or what have you sort of complicating the projection for next year?

Paul Brody

Yes, it's -- that's a more intricate question as to -- we obviously continue to pay income taxes in foreign jurisdictions. And then there's the question about losing some of the foreign tax credits because they're limited in a different way than they were before. So I mean, that's a -- it's a fairly complex question you're asking. But as Thomas said, the drop in the U.S. rate doesn't just fall straight to the bottom line as a result of some of those complexities.

Doug Mewhirter

That's actually a very helpful answer. And my final question, so you look at the Market Making segment, if you try to just isolate this quarter, \$25 million net revenues, \$17 million of noninterest expense. So it sounds like that, that transition is pretty much done. Is that sort of a rough order of magnitude of where we would see that segment? Of course, adjusting for the market fluctuations, which would adjust -- make the revenues bounce around. Or is there going to be still some of that \$17 million might sort of creep over onto the brokerage side or actually be shedded with additional cuts?

Thomas Peterffy

It certainly not will come over to the brokerage side. It's -- you're talking about the revenue, yes?

Doug Mewhirter

Well, no, I mean, the cost base, that \$17 million cost base, will it...

Paul Brody

So the answer is some of it has yet to go. As we said, at a point in time, at the end of the year going forward, we've migrated about 82% of the costs that we expected to migrate, which was the \$40 million annual run rate. So looking at the fourth quarter, it's a -- you have to also look at how much was actually migrated during the fourth quarter, and it's a little bit more complicated because it didn't all happen on the first day of the fourth quarter and so forth. But I can tell you that we absorbed about \$5 million of expense during the fourth quarter. As we had previously indicated, we absorbed \$2 million in the second quarter and \$3.5 million in the third quarter. So for the year, as actually migrated, it was about \$10 million or \$11 million. But we're at a more advanced run rate going forward because of those -- those are actual resources and now they're fully absorbed. Those resources that were migrated are fully absorbed into brokerage.

Operator

This question comes from the line of Kyle Voigt with KBW.

Kyle Voigt

Just one follow-up on Doug's question. I think he was asking in terms of -- on the expense side in the Market Making segment. But on the revenues, is that \$25 million, is that the right -- I think you said order of magnitude, is that the right order of magnitude we should be thinking about in terms of revenues? Is there another step down as we head into 2018 as you continue to pull back there?

Thomas Peterffy

Well, on the long run, we expect it to peter out to 0 basically.

Paul Brody

Along with the expenses, of course, right?

Kyle Voigt

And then, I guess, just one on the -- you said you hadn't started investing in the agency securities yet. Just wondering if you would give us any time line there and then potentially help us quantify any type of uplift this could provide for that 115 basis point current yield on seg cash.

Paul Brody

Right. So we decided it deserves some further study on both pricing and risk management, which is why we weren't in a hurry to roll it in. We don't expect it to have a very large impact. It's -- that market is also in flux with interest rates changing more rapidly than they had been in the past. So we're giving it more study. And we might be able to introduce it in the coming quarter or two. But I don't think it'll -- it's -- it will improve net interest income, but depending on what the market gives us, probably not by a huge amount.

Operator

And that concludes today's question-and-answer session. I'd like to turn the call back 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. And 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.

Operator

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