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E*TRADE Financial Corp. (ETFC)

Q3 2016 Earnings Call

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Rodger A. Lawson
Executive Chairman

Karl A. Roessner
Chief Executive Officer & Director

Michael A. Pizzi
Chief Financial Officer & Executive Vice President

OTHER PARTICIPANTS

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Steven J. Chubak
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Chris M. Harris
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MANAGEMENT DISCUSSION SECTION

GAAP AND NON-GAAP FINANCIAL MEASURES.....

- During the call, we will also discuss non-GAAP financial measures
- For a reconciliation of such non-GAAP measures to the comparable GAAP figures and for a discussion of additional risks and uncertainties that may affect the future results of E*TRADE Financial, please refer to our earnings release furnished on Form 8-K and our 10-Ks, 10-Qs and other documents the company has filed with the SEC
- All of these documents are also available at about.etrade.com
- Note that we have not reconciled our forward-looking non-GAAP measures, including non-GAAP adjusted operating margin to the most directly comparable GAAP measures because material items that impact that measure are out of our control and cannot be reasonably predicted

Rodger A. Lawson
Executive Chairman

Q3 HIGHLIGHTS.....

Opening Remarks

- We are at a critical juncture for E*TRADE, and this last quarter was particularly significant
- While all of you tuning in are certainly aware of the more headline-inducing changes we made, I'm going to take a few minutes to reiterate the impetus for those changes, before giving a bit of color on the board's current thinking about what constitutes success, and then finally provide my observations of the company's current trajectory from my new unique vantage point as an insider

Replacement of CEO

- First of all, our decision to replace the CEO
- E*TRADE has spent the last several years appropriately focused on the most impactful opportunities in its path: namely, managing the wind-down of the legacy balance sheet, bolstering its risk and operating foundations, improving all facets of its regulatory standing, and, of course, unlocking and deploying a meaningful amount of capital to the benefit of its shareholders
 - Many of these efforts were interdependent, and some were set in motion many years ago
- But over the last three years, we've harvested most of the fruit of this labor, and the stock appreciated in commensurate fashion
 - During that period, the board has vigorously supported the management team in pursuing all of those matters

Core Brokerage Business

- At the same time, however, we, as a board, have always remained fully cognizant of the need to develop ongoing avenues of growth and value creation once the fix it story had been executed
- Key to that growth has always been our core brokerage business
- And as you would expect, we've remained particularly focused on the major business driver metrics of accounts, DARTs and assets
- I believe our business driver focus has always been thoughtful and certainly alert to the impact of the vagaries of the markets
- But having said that, as a board, we have become increasingly concerned with both current business driver results as well as the forward trajectory
 - Given that, we faced two choices: give it some more time or take action
 - We ultimately favored the latter and made changes at the top of the company
- Again, the former CEO was a good steward of the company through its recent chapter, but we believe shareholders are better served with a reconfigured executive team to align the company for future growth

Karl Roessner Leadership

- In putting together that team, we strongly believed that Karl Roessner was the natural choice to lead E*TRADE
- Karl has a deep history with the company, substantial experience and knowledge across all elements of E*TRADE's business, a sharp commercial acumen and is a truly trusted partner to the board, as well as an ongoing credible presence with our regulators, which you all know is extremely important
- Additionally, capitalizing on the completion of our OptionsHouse acquisition, Karl, again, with strong support from the board, has taken advantage of an opportunity to fill an important gap in our brokerage leadership with the appointment of Michael Curcio, as our Chief Brokerage Officer
- Buttressed by the continued and noteworthy service of Mike Pizzi, as CFO, along with our other leaders, the board feels truly confident that this structure
 - And this executive roster is well-suited to accomplishing our goals
- As for me, I've joined the team in a full-time role as Executive Chairman to ensure Karl has unfettered access to my years of industry experience, as well as to support the board's agenda on a daily basis, while working constructively with Karl and the management team
- My role is not a permanent one, and I look forward to returning to non-executive Chairmanship in due time
- With the leadership team in place, however, I want to stress that we are not just looking to implement the right structure, but to drive tangible results to shareholders, which brings me to my next topic
- What constitutes success for the company?

Growth

- In short, there are three areas: Growth, improved operating leverage and a sense of urgency
- I'll touch on each of these, none of which are mutually exclusive, and then pass it over to Karl to elaborate farther
- Starting with our growth ambitions, balance sheet expansion and breaking through the \$50B threshold is well underway and is in the more than capable hands of Mike Pizzi and his team for implementation
 - I'm sure that will be discussed further today

ORGANIC AND INORGANIC

- Our growth focus on what we characterize as key business drivers comes in two flavors, organic and inorganic
- Organically, the key growth levers are well known
- Namely, how we market our company to customers and prospects; how we package and promote our products; and finally, how we capitalize on the corporate services channel to drive more meaningful activity
 - By addressing these elements, we feel strongly that the company can make up lost ground relative to our industry peers
- And as previously stated, we quantify that as a 2 percentage point to 3 percentage point improvement in our rate of annual organic growth, across accounts, assets and trades
- Inorganically, growth may come from in-sector opportunities as well as adjacent ones, provided an acquisition supports our core business and aligns with our digital ethos
- There is currently plenty of public chatter surrounding this topic, and I won't indulge it further, other than to say this, the E*TRADE board is highly value-conscious and the company's leadership is smart and methodical in their evaluation process
- Translation; we will not overpay, and we will not do anything stupid

Operating Leverage

- Moving now to improving operating leverage, our perspective is very simple; we must find money to spend money
- In this regard, the team is steadfast in their commitment to managing expenses through an operating margin framework
- And Karl will speak more about this, but I'll mention that I've been impressed with how methodically the new leadership team has driven this goal forward in just a few weeks
 - I'd also add that this is an ongoing dynamic process
- We will always be looking to enhance our operating leverage in the future, both through sound management as well as the intelligent application of technology
 - This is an attitude possessed by all good companies and is most certainly not a once-and-done approach

Sense of Urgency

- Now, what do we mean by a sense of urgency? Philosophically, we believe it falls on the board and the senior management team to create and establish an ongoing sense of urgency in our business endeavors
- With our capital initiatives and options relatively clearly defined, it's time for the core brokerage business to embrace initiatives to move forward more quickly
- As a board, we certainly believe the new company leadership team can produce the desired results, but it is critical that we also set and abide by a serious timeline for that to unfold
- Last month, I said that was 18 months to 24 months, at which point the board would take stock and assess options for the company if our goals are not achieved
 - That timeline stands and has been embraced by management as motivation to get things done
 - And I find that extraordinarily encouraging

Observations

- Finally, I would like to share my observations of the company from the inside
- I'm impressed with the management team's ability under Karl's leadership to make difficult decisions to drive results and to focus on our goals
 - This includes the work to integrate OptionsHouse, the meaningful changes to our organizational structure and the intense drive to address expense issues

Karl A. Roessner*Chief Executive Officer & Director*

BUSINESS HIGHLIGHTS

Opening Remarks

- I want to start by building on Rodger's observations with my own
- With 7.5 years at the company, I can confidently state that I've never seen our leadership team act with more purpose or cohesiveness than it has over the past month
- I'm truly impressed and believe we are all rowing in the same direction
 - This is largely attributable to how we've realigned the team, but certainly aided by that board-encouraged sense of urgency that Rodger mentioned

Executive Leadership Team and Organizational Changes

- I will start with the executive leadership team and the changes we made
- First, with our most crucial goal centered on the brokerage business, installing a strong brokerage head was a key priority, and Mike Curcio has deftly filled that role
- Next, to centralize functions to directly support our business goals, I moved Marketing and Corporate Services from the executive office to Mike Curcio's organization
- Further, we removed an inefficient senior layer of business line COOs along with an unnecessary support and consulting structure across the company
- It's easy to speak to growth, but if the internal environment isn't conducive to execution, it can be an impossible order
 - So, we have made all of these changes with an eye on getting back to our lean, scrappy, brokerage roots
- Separately, we've consolidated oversight of our compliance and AML functions under Paul Brandow, as Chief Risk Officer; aligning the structure to be consistent with industry standards and regulatory expectations
- All of these organizational changes foster a more accountable and collaborative culture, one which I believe will produce measurable, positive results and one which comes at a significant savings to the P&L
- To be clear, we have a sense of urgency and are focused on results

Key Priorities

OPTIONSHOUSE

- The key priorities to which we will hold ourselves accountable are: integrating OptionsHouse

- This one is pretty obvious, but it sits at the top of the list because of the importance that hangs on getting this right
- It's imperative that we capture the full value associated with the deal, and we're on track to accomplish this

TRADING

- Refocusing on trading
- We were once the undisputed leader in this space, but have notably fallen behind
- We need to re-earn this top spot and the purchase of OptionsHouse is only the beginning of these efforts
- Deepening engagement with existing customers

INVESTING OFFERINGS, RISK AND REGULATORY

- Reinforcing our long-term investing offerings remains a crucial component of our efforts
- We offer the same products and services that many of our customers use elsewhere, and need to create greater awareness of these offerings, particularly through our marketing efforts
- Finally, never losing sight of all that we've accomplished on the risk and regulatory fronts

Performance

- These key priorities are meant to improve performance across our core metrics, and specifically generate account and asset growth and trading activity where, as Rodger noted, we're targeting a 2 percentage point to 3 percentage point improvement in our annual rate of growth
- Additionally, we're turning up the focus on our derivatives mix with an aggressive target of growing it to 35% of DARTs within the next two years

Long-Term Investing and Cost Savings

- Further, with respect to long-term investing, we aim to grow our managed product AUM to \$6B within the next two years
- In tandem with our commitment to grow the business, we also understand our responsibility to be good stewards of shareholder value through operational efficiency
- As a management team, we took a hard look at our operating model during the quarter, considering the impacts of the OptionsHouse acquisition and of our organizational realignment
 - As a result, we identified significant cost savings in the combined organization to be realized as part of our mandate to become more nimble, while maintaining our strong risk culture, where I believe we are standard bearers in many respects

Deal-Related Expense Synergies

- With regard to our \$49mm of deal-related expense synergies, we've completed \$15mm as of this call, with the balance expected to be realized by Q3 of next year when we complete the OptionsHouse integration
- Also, related to the close of the transaction, we had \$7mm charge in the restructuring line
- Separately, following a focused review of our structure and expenses, this quarter we have eliminated an additional \$21mm of annual run rate expenses
- The restructuring line also reflects charges of \$18mm, primarily related to these actions

Net Income, Restructuring and Acquisition-Related Expenses

- Moving on to our results, we reported net income of \$139mm or \$0.51 per share
- There's a decent amount of noise in these results, which boosted the bottom line by \$19mm or \$0.07 per share in total
- On a pre-tax basis, these items were \$6mm of severance related to our prior CEO, the \$25mm of restructuring and acquisition-related expenses I just mentioned, and \$62mm provision benefit

Brokerage Account Growth Rate

- On the metrics, excluding the OptionsHouse accounts we acquired, we added 14,000 net new brokerage accounts during the quarter, and our attrition rate was a healthy 8%
- Our brokerage account growth rate was 1.7% for the quarter, down from 2.8% in the prior quarter
- We also added \$1.7B in net new brokerage assets, excluding OptionsHouse assets, which compares to \$1.6B in the prior quarter and \$2.1B a year ago

Customer Assets

- We ended the quarter with \$307B in total customer assets, including \$24.4B in fee-based assets, which are predominantly mutual funds and managed products
- We ended the quarter with \$3.7B in managed product AUM, including \$176mm in Adaptive Portfolio, our newly-launched robo solution
- Our DARTs for the quarter were 152,000, flat with the prior quarter and down 3% y-over-y
- Excluding OptionsHouse, our DARTs would have been 146,000 for the quarter, down 4% sequentially and down 6% y-over-y
 - The quarterly decline reflects some seasonality and a fairly quiet macro market environment
- The y-over-y comparison is a tough one given the turmoil in global markets that led us to a single-day trading record in August of last year

Derivatives

- Approximately 26% of our DARTs were in derivatives in Q3, which includes a 1.7 percentage point boost from OptionsHouse over the final 15 days of the quarter
- Pro forma with OptionsHouse for the full quarter, derivatives would have been 30%
- Our customer margin balances ended the quarter at \$6.8B, including approximately \$300mm from OptionsHouse

CLOSING REMARKS

- In closing, we're working hard to align the organization and all of our efforts for growth
- And I'm confident in our ability to achieve our goals
- I hope my remarks serve to show that we mean business when it comes to growing our business
- I look forward to delivering and to keeping you all apprised along the way

Michael A. Pizzi

Chief Financial Officer & Executive Vice President

FINANCIAL HIGHLIGHTS

Net Income and Revenues

- For the quarter, we reported net income of \$139mm or \$0.51 per share
- This compares to net income of \$133mm or \$0.48 per share in the prior quarter
- It also compares to adjusted net income of \$96mm or \$0.32 per share in the year-ago quarter, which excludes \$413mm of pre-tax charges related to the termination of wholesale funding obligations
- Revenues for the quarter were \$486mm, up \$8mm from the prior quarter, largely related to higher customer cash held by third-parties and up \$55mm on an adjusted basis from the year-ago quarter, which is attributable to the benefits from our wholesale funding termination and the Fed rates hike
- Net interest income was \$287mm for the quarter, up \$1mm from the prior quarter as a 5-basis-point reduction in net interest margin was offset by \$1.1B larger average balance sheet

Net Interest Margin

- Our net interest margin of 259BPS decreased primarily due to faster prepayment speeds on the securities portfolio, continued run-off of higher yielding of the legacy loan portfolio and an unfavorable shift in margin balances to lower priced tiers
- Our average reinvestment rate is now in the range of 175BPS to 200BPS
- We continue to expect our full-year net interest margin to be 260BPS to 265BPS with Q4 in the mid 250s basis points
 - This also assumes no change in the Fed funds rate, and that margin balances remain constant with their current levels

Commissions, Fees & Service Charges and Other Revenues

- Commissions, fees and service charges and other revenues were \$185mm, up \$7mm from the prior quarter and up \$15mm vs. the year-ago quarter
- Compared to Q2, commissions revenue increased \$1mm as DARTs were flat and average commission per trade increased \$0.15 to \$10.97
 - This was driven by higher options and stock plan mix
- Relative to the year-ago quarter, commissions revenue decreased \$1mm on lower trading activity, partially offset by \$0.10 increase in the average commission per trade also related to higher options and stock plan mix
- Our DARTs of 152,000 this quarter, include 6,500 from OptionsHouse for the 15 trading days of the quarter that they were under our umbrella
- Fees and service charges revenue increased relative to both the prior quarter and the year-ago quarter
- We recorded \$3mm sequential increase on customer cash held by third-parties, as off-balance sheet cash grew amidst customer net selling

AVERAGE YIELD

- Meanwhile, we had a marginally higher average yield on those balances following the conversion of \$4B of money market funds into our sweep program in early September
- The \$16mm y-over-y change reflects higher yields on third-party customer cash as well as increased asset-based fee revenue

- For some context, the average yield on customer cash held by third-parties was 47BPS, up 6BPS from Q2 and up 29BPS from Q3 of last year
 - We expect this rate to move in line with broader short-term benchmark rates
- The fees and service charges line also contains approximately \$3mm from OptionsHouse, which includes revenue from their customer margin and cash balances
 - Once we convert their third-party clearing arrangements in Q3 of next year, we will capture this revenue through NII

Securities & Other Gains and Operating Margin

- Securities and other gains were \$14mm, up \$10mm from the prior quarter as we repositioned portions of the portfolio around Brexit-driven market volatility
- For Q4, we expect gains to return to the \$10mm range
- Non-interest expense for the quarter was \$323mm, up \$28mm sequentially including the unique items Karl mentioned
- Our adjusted operating margin, which excludes provision, was 34%
 - This was driven lower by approximately 6 percentage points related to CEO severance, restructuring and acquisition-related costs
- For Q4, we expect our adjusted op margin to be approximately 35%, which reflects the full quarter impact of OptionsHouse

Provision

- Moving on to the provision line, we recorded a benefit of \$62mm for the quarter
- The allowance ended at \$235mm, a reduction of \$58mm in the quarter as net charge-offs were a recovery of \$4mm
- The current period provision benefit resulted primarily from updated performance expectations based on the sustained outperformance of the high-risk HELOCs
- The current period also reflected recoveries in excess of prior expectations as well as payoffs on loans converting to amortizing
- We are now 73% through the HELOC conversions, providing ample data on the performance of these loans
- Additionally, the portfolio continues to reduce in size, ending the quarter at just \$4.1B, down \$315mm from the prior quarter
- Further, our allowance coverage ratio remains healthy at 6% of the total loan portfolio

Capital

- Moving on to capital
- We distributed \$125mm up to the parent during the quarter, including \$85mm from the brokers and \$40mm from the bank, which was below Q2 bank net income of \$106mm as we preserved capital at the bank to fund planned balance sheet growth
- I'd note that with respect to brokerage distributions in connection with the merger of our clearing and securities entities, we intend to distribute approximately \$100mm to the parent in Q4
- In the future, brokerage distributions should be consistent with excess capital generation
- As for the bank, we intend to utilize the majority of its capital generation to fuel our balance sheet growth, but plan to distribute \$50mm to the parent this quarter

Assets and Costs

- On assets, we ended the quarter at \$49.2B and have our sights on crossing \$50B in H1 next year
- With significant customer net selling of \$2.4B in the quarter, the conversion of \$4B of money market funds to our sweep program and the addition of OptionsHouse, off-balance sheet customer cash is \$14B
- With around \$3B not available to bring on balance sheet, on a pro forma basis, we have just shy of \$11B of cash for balance sheet growth
- On a related note, with work on the enhanced regulatory build-out well underway, we feel good about crossing \$50B in H1 next year, and anticipate ending Q2 with total assets of approximately \$56B
- As for the cost of the build-out, we continue to expect \$50mm over two years with \$15mm in annual run rate expense
 - The costs we have incurred to-date are minimal and included in our adjusted operating margin guidance for 2016

Leverage Ratio

- The bank's leverage ratio of 8.5% implies about \$180mm of capital above our current 8% target
- We intend to seek regulatory approval to lower that target to 7.5% early next year, which would free up an additional \$180mm
- As for parent capital, we ended the quarter with Tier 1 leverage ratio of 7.3%, down from 7.5% last quarter but above our floor of 7%

Corporate Cash

- Corporate cash ended the quarter at \$306mm, a decrease of \$217mm from the prior quarter
- We issued \$400mm of 5.875% Tier 1 qualifying non-cumulative perpetual preferred stock during the quarter to partially fund the purchase of OptionsHouse
- The remainder of the \$725mm purchase price was funded with cash, thus contributing to the decrease during the quarter
 - This was partially offset by \$125mm of subsidiary dividends
- Barring any other attractive uses for parent cash, we will be in a position to resume share repurchases in H2 2017

SUMMARY.....

- To briefly summarize, Q3 was a busy quarter
- We completed a meaningful acquisition, made progress achieving our expense synergy targets, aligned the company to refocus on core growth, identified additional cost saves, positioned the balance sheet to deliver considerable incremental value and continued to exhibit marked progress on reducing risk

QUESTION AND ANSWER SECTION

Richard H. Repetto

Sandler O'Neill & Partners LP

Q

I guess the first question is, Mike, on the reserve releases, again, we have a big reserve release and you explained how the risk has taken out. What's the guidance going forward, I think this is Q4 in significant releases?

Michael A. Pizzi

Chief Financial Officer & Executive Vice President

A

Sure, Rich. I guess, you heard me say for some time that we've been seeing the data come in at or better than our modeled expectations. What you have this quarter is really a recalibration of those expectations, and that is why the release is larger or increasing. We finally had a sample size large enough to really recalibrate the allowance process and model based on the amount of conversions that have been coming through. And so, this amount that's being released catches it up to that new guidance. So, from a look-forward perspective, the best guidance I can give you is zero.

Richard H. Repetto

Sandler O'Neill & Partners LP

Q

Okay. Okay. And I'll just do one follow-up here, but I guess the question is, Rodger, you've laid out the 2% to 3% growth target and over an 18-month to 24-month period, we're not going to talk directly about any acquisition or M&A activity, but, I guess, I would like to know what happens if you don't meet that 2% to 3% hurdle in that time period?

Rodger A. Lawson

Executive Chairman

A

Okay, Rich. Thanks for the question. I think this is a very important question and a lot of people, I'm sure, are thinking of the same question. So, thanks for asking it.

In terms of my response, let me give you a little bit of context, and I may answer this question slightly longer than normal. We picked the 18 months to 24 months, because I think we all thought that was an adequate time to really show the board and to show shareholders that we could get along the growth path that we described at the Barclays Conference. Actually we talked, Rich, more about organic growth and may well be that an inorganic opportunity comes along during that process, but just in the 18-month to 24-month period, we thought it was adequate time to show we could deliver. And I think from a board point of view, we need to feel very, very comfortable that we can continue to add shareholder value.

So, now let's go to the potential outcomes, the heart of your question. Let's take a negative outlook first. What happens if we can't deliver? When we conclude that we can't get to those kind of growth rates and that we can't, therefore, continue to deliver shareholder value. And I think that there were series of options – more options than one might think. The one which obviously everyone goes to is a sale, but there may be other options in terms of partnerships. We have weaknesses we noted in our business model. If we can't correct them ourselves, it might be feasible to correct them with partners, but clearly a sale partnerships, there are a series of different scenarios which crop up. The only thing I would say which is definitive is, the board will not allow loss of value.

Now having said that, I've got to look for the positive side. Let's assume we do deliver, which because it goes both ways. And I recognize your question was if we don't. Well, let's assume we do deliver. We actually, at this moment in time, really consider that is possible. I actually just speaking for myself, but I know I was speaking for Karl and Mike and Brett, and we're very, very impressed with what's happening here.

And there is a real commitment to deliver on the growth drivers that we talked about at the Barclays Conference. There are a body of people at E*TRADE who really want to succeed and want to see the company succeed. So, even though we are talking about what happens if we don't succeed, I think it's not out of order to say that we believe very strongly we will.

Now having said that, I'm sure we have the odd cynic in the phone audience, who would say that's just words. but I'd give you a little reminder, I came on this board at the beginning of 2012 along with my board colleague, Becky Saeger from Charles Schwab. I remember at that time, Rich, a lot of doubts were being expressed on whether we could deliver on what I'd characterize as the low-hanging fruit, but it really was tough to achieve and a lot of doubts were being expressed then, could we refinance our debt, could we improve our funding costs, was our portfolio going to drown us, what was going to be happen to the HELOCs, would we ever get the benefit of our DTA given the fact that the DTA – if you don't have earnings, how the hell can you use your DTA?

And I think that doubt by the way, wasn't my interpretation of body language. I mean the share price sucked, it was somewhere in the middle or low single-digits. And yet 4.5 years later, here we are. So I think at that time, there was real doubt as to whether the management team could deliver. Rich, I think we've put our money where our mouth was and delivered, and good credit to them.

So now, as we go the next 24 months, we will, as a board, seriously consider how we're doing and we'll consider all options. So, this is not weaseling out on anything. We will consider all options. We understand what our role is and the value we have to deliver, but I will say again given the kind of people we've got at E*TRADE, I think we believe that we can achieve the value goals we'll set. And clearly that will mean an improvement in shareholder value as we go forward. So, I've given you a longer answer, Rich, than the question you asked, but I hope it's at least illustrative of what our thinking is.

Steven J. Chubak

Nomura Securities International, Inc.

Q

I really appreciated all the detail you provided to the last question, I'm going to take a slightly different take here. As we think about some of the best avenues for creating long-term shareholder value, and you certainly framed it in that context in terms of how you're thinking about the long-term brokerage strategy, can you articulate specifically how improving the organic growth profile by 200BPS to 300BPS would justify operating on a standalone basis, and there's maybe a better alternative or more accretive path vs. a combination with one of your largest brokerage peers.

Rodger A. Lawson

Executive Chairman

A

Well, actually, Steven, again this is a very, very good question. I can't tell you what the precise algorithm is that says 2% to 3% equals an accessible level of shareholder appreciation. But what I would say, that that level of growth gets us to market standards because that's how far we're behind, it will run through – assuming we acquired the types of accounts and the types of trading activity, the types of margins, all things you're obviously very well aware of, and we have absorbed a huge amount of fixed expense in the company over the course of the last two years or three years. Remember, Steven, some of the prepared remarks addressed the fact that we really have fixed the operating foundations, I think were the words we used, as a company.

So, I think the reality is that level of growth will get us to a rate of return which I think is comparable to our competitors in terms of pure organic growth. We did say 18 months to 24 months. The world doesn't end at the end of 24 months. I think we'll be continuously reviewing that.

We do have weaknesses in the business model. We recognize that. We would be happier if we had a developed RAA channel. We don't have it. Clearly, if we could have one acquired either organically or at a sensible price, I think it would make us more competitive. But I think the 2% to 3% will deliver comparable rates of increased return. I think it also is a rallying cry for getting all the troops in the company to pursue what has to be done in order for us to be as competitive as we are. But having said all of the above, there really is never an end date. It's a continuous evolution and we're going to have to keep evolving the company as we go forward.

Steven J. Chubak

Nomura Securities International, Inc.

Q

Thanks for all that color, Rodger. And maybe switching gears for a moment, but still, I guess, focusing on the strategy but thinking about things in an M&A context. I recognize that you're not going to speak about recent announcements from some of your competitors, but just looking at the broader M&A landscape and opportunity, I'm wondering whether you would consider large scale acquisitions during this current 18-month to 24-month time window. It sounded like you might consider some opportunities to maybe enhance capabilities. I'm speaking specifically about any large scale opportunities given that you're still working through an OptionsHouse integration and could that impact your appetite or willingness to acquire any other properties?

Karl A. Roessner

Chief Executive Officer & Director

A

So, it's Karl. So, looking at sort of where we are right now, and what's happening out in the landscape, just keeping in mind, the management team and the board at this company are always focused on what's going to drive company value, and more importantly what's going to drive shareholder value. So if there are acquisitions out there, whether it be a scale acquisition or to be a product extension or a channel that we don't have right now that could drive revenue, and when we looked at it as methodically as we do anything that we look at, if it were to drive shareholder value, we'd definitely be interested, right? But we'd take a look at it through the same lens. We'd communicate with our regulators to make sure that everybody was sort of teed up on it before we moved on it. Right? We're very disciplined in our approach to things; we have to be.

Rodger A. Lawson

Executive Chairman

A

And, Steve, if I could just add a comment to that. I mean, we're always going to look at acquisitions, maybe just because we're nosy and we want to know what the competition is up to or it may well be because they represent a real opportunity to grow scale or enhance our business model, which is the driving issue. So we're always going to look.

Steven J. Chubak

Nomura Securities International, Inc.

Q

Right. Okay. And then just one more modeling question for me, if I may, and maybe it's better suited for Mike. But, you'd mentioned that the service charges and fee line, there're various puts and takes. So you have to consider the OptionsHouse contribution, but presumably there're some benefit from off-balance sheet deposits which will go away. How should we think about the run rate for that line item, once, all of the off-balance sheet deposits have been swept to the bank and you have the full contribution from OptionsHouse?

Michael A. Pizzi

Chief Financial Officer & Executive Vice President

A

Yeah. Once all about – if you just look at the amount of off-balance sheet cash at \$14B is predominantly now all in a sweep program. That's going to shift down, about \$3B of that will remain off-balance sheet. The rate that came in this quarter is really market determined. And so that market determined rate will move with benchmark rates both LIBOR and fed funds rates.

Chris M. Harris

Wells Fargo Securities LLC

Q

A question on your margins. I appreciate the guidance for Q4, but there's a lot of moving parts as we get into 2017. So, any comment or anything else you guys can kind of guide us to as how we should be thinking about the trajectory of your margins as we get into next year?

Michael A. Pizzi

Chief Financial Officer & Executive Vice President

A

Yeah, Chris. There is a lot of moving parts, and we're going to have a lot more to give you firm guidance on when we complete our budget and capital planning process, which we're in the midst of now. So, we will be giving you a firm target.

Right now, with the integration of OptionsHouse, you can see that the OptionsHouse margin, being a little bit lower than ours, is driving Q4 margins down a bit on an adjusted basis. We think, as the synergies come on line, that operating margin improvement from the acquisition will come through. And we should be operating next year to comparable operating margin to this year, but we'll be back with more specificity on that at the next call.

Chris M. Harris

Wells Fargo Securities LLC

Q

Okay. Great. And then one quick other question here on expenses. The run rate savings you guys have talked about \$21mm. Can you expand a little bit on where that came from? Is any of that in client facing positions? And is that sufficient enough to cover your growth expenses for next year?

Karl A. Roessner

Chief Executive Officer & Director

A

So the \$21mm really came from the elimination of the positions that I talked about in the prepared marks. And just looking at our organization and really getting the alignment throughout, particularly on the brokerage side itself making sure that the right pieces are all under Mike Curcio so that we can get appropriate execution and deliver on some of the growth that we've talked about. We don't plan on that \$21mm that came out funding growth or otherwise.

If we are going to continue to grow and continue to find new projects to invest in, we'll have to find that within the business. And as Mike just laid out, right, we plan to sort of stay within the op margins that we've been at now. And I think we said that a couple of times now, so happy to repeat it.

Nothing was customer facing, right? We don't intend to impact the customer in that way. These are really just looking through and garnering efficiencies so that we've gotten the right people in the right places to do that job.

Conor Fitzgerald

Goldman Sachs & Co.

Q

Rodger, maybe just to start with you. I think you talked about, you thought that there was a lack of emphasis on growth and then it came up short vs. the board expectation. Can you give us a little more color on where exactly you felt the strategy fell short and kind of what gives you confidence that the new management team can execute on those targets you laid out?

Rodger A. Lawson

Executive Chairman

A

Sure, Conor. Thank you. A good question. I think we all feel that our marketing aggressiveness has been diminished over the course of the last few years. I don't think we've been generating the prospects and the new accounts at a rate which is commensurate to either what we were spending or what we've achieved in the past. So without wishing to wash any dirty linen in public, I think our view would be that we can make material progress in our marketing endeavors. And that, I think, was a relatively – that what I would say, Conor, is the most dominant factor.

We, as a company, as you're well aware had distractions over the last five years or six years and maybe that takes some of the emphasis off, but I think we have dropped the ball to a degree. And personally, I think we've taken, as we ought to great credit for the fact that we have really fixed the foundations of the company, as per my prepared remarks. And we've also generated the kind of financial returns, which I alluded to earlier when I said I think there were doubts we could do it. I think all credit to Michael Pizzi and to his predecessor Matt Audette and others because they've really delivered. But I think during that phase we may have taken our eye of some of the marketing endeavors and we thought that financial success was an end in its own right as opposed to a means to an end.

I think now we need to get – as you will note over the course of the next few months, we need to become much more aggressive in that space. And that's why I am earnestly optimistic that we can make good progress there.

Conor Fitzgerald

Goldman Sachs & Co.

Q

That's very helpful. Thank you. And when you talk about your marketing effort falling short, would you consider sacrificing margins in the near-term to drive growth longer term?

Rodger A. Lawson

Executive Chairman

A

Well, you could say we would always consider it. If in fact it was going to add materially to the value of the company, I think the answer is, yes. Do I think it's likely to happen, which I think is the more pertinent question is, no. And I just don't think the opportunities at the moment present themselves, but we are open to it. We were open – and the board perspective and the senior management perspectives, we want to see the company grow. I mean, I know we overuse that word grow and growth and whether it's a Barclays Conference or now, but we want to see the company grow.

And so, if there was justification for a significant investment in the short-term because we can not only drive share and growth, but it has tangible financial value. I mean, we just not going to add accounts for the sake of it, but if you can drive tangible financial value, we would, we would invest, but again at my early comment at the moment, I don't think we see that opportunity.

I don't know whether Karl you would like to comment on that.

Karl A. Roessner

Chief Executive Officer & Director

A

No, look, I think that's right. I think the way you sort of laid out, where we are right now on the brokerage and the amount that we've invested previously in our foundational assets. We have to do that, right? If it's a necessary evil that we have to take care and we had to put ourselves back and then place it. We do get the operational flexibility that we now have. And the way I look at it, that same low-hanging fruit that we had on the financial side of the house in the balance sheet, we actually have a lot of opportunities on the brokerage side, right. We're very focused on risk in second and third lines of defense and getting that all cleaned up, and I think we now have an opportunity. But my own humble opinion is, we're not going to sacrifice in terms of changing our op margin or eating into the good things that we've already done for short-term wins. So it has to be long-term value based in order for us to invest in it.

Conor Fitzgerald

Goldman Sachs & Co.

Q

That's helpful. And Mike, just maybe one cleanup question for you, if I could. The operating margin of 35% for Q4. Does that include any integration expenses? And if I kind of back out the severance and integration charges that you guys are taking in Q3 and Q4, does your 38% margin target for the year still hold?

Michael A. Pizzi

Chief Financial Officer & Executive Vice President

A

Yeah. So, for next quarter, the 35% includes any planned integration expense as well as having options out in the items for a full quarter. Now keep in mind, we are in the midst of an integration and there are things that are planned for next year. If we move faster that may move some of that into Q4. Right now though, that is the plan. So that's the information that we have.

In terms of the year, if you look at sort of a one-time items, they're pushing our adjusted operating margin down in the period to 34% by about 6 percentage points. So, if you take those one-time items out, which are about \$31mm or \$0.07, throughout and then take the \$35mm, you'll see that we're coming in on target.

Michael Roger Carrier

Bank of America Merrill Lynch

Q

So, just a question on the expense outlook. So if I look at this quarter, I think on a clean basis, you're at \$292mm. I guess, first, I just wanted to understand the \$21mm that you took out in the quarter, is that sort of in the run rate or is there kind of a full quarter to see?

And then when you guys look at it, and this is more into 2017, when you look at it in terms of what you include on the expenses or those target margins, are you including the OptionsHouse like the integration cost and like the bank cost or is any of that going to be like restructuring or acquisition related? Just so we understand kind of what you're looking at when you're talking about the margin?

Michael A. Pizzi

Chief Financial Officer & Executive Vice President

A

Yeah. So, the costs for this quarter came in more towards the backend of the quarter overall. So, from a run rate perspective, you probably see it pickup a bit. Now keep in mind, when we look at next quarter, we had OptionsHouse in the income statement for 15 days this quarter, it will be in for a full quarter. So that will affect

some of those expenses. We're also starting to see some of the commitments that we've made on the risk work to get through the \$50B barrier, some of those investments are coming through as well. So that's why we're giving you an operating margin target, not specific expense guidance.

Looking into next year, we think that we would like to give you a target on the January call that will encompass all our expected and planned expenses that would include the CCAR expenses, the regulatory build out expenses for that as well as all of the integration expenses of OptionsHouse.

Michael Roger Carrier

Bank of America Merrill Lynch

Q

Okay. Got it. And then maybe just on the strategic side, you guys talk a lot about like the brokerage business, yet on the other side, you're growing the bank and you're breaking through the \$50B. Just like from a strategic standpoint given like the focus unlike the brokerage growth, do you think that limits you in terms of your options out there whether it's on the acquisition side with regulators, or is it okay, meaning, to go down that path and still have like kind of full flexibility on the brokerage part of the business?

Karl A. Roessner

Chief Executive Officer & Director

A

Yeah. So, look, I look at it as we have to grow the brokerage, right? It's who we are and our roots, we're a retail brokerage and that's sort of what we do every day. And the organizational alignment, the add of OptionsHouse, some of the capabilities that came on were the first things that we've done towards that end. Growing the balance sheet and taking the bank up over \$50B, as long as we do it smartly as we have done around here will not lead to any additional constraints on other things we're going to do. I mean, Mike Pizzi can talk to you a little bit about capital and some other pieces. But my own view has always been that the bank adds quite a bit of power to our returns, but Mike, I don't know if you want to add anything on the capital side of our limitations front.

Michael A. Pizzi

Chief Financial Officer & Executive Vice President

A

Yeah. I don't think that the decision around the balance sheet creates any limitation in flexibility. It's going to be a lot of work. We've been organizing around that and building our plans accordingly. And we've begun to make some progress in all of these key areas. But I don't think it limits any flexibility in what we're trying to achieve in the growth of the core business.

Michael J. Cyprys

Morgan Stanley & Co. LLC

Q

Just curious as you're thinking about accelerated growth here. If you could just talk a little bit how you're using customer data and analytics today to improve your customer acquisition, drive greater engagement and retention. And just longer term, how you're thinking about the opportunities set from that?

Karl A. Roessner

Chief Executive Officer & Director

A

So, I'd rather approach it from the opportunities' perspective, because quite honestly I think we can do a much better job of using data, particularly in our marketing efforts and being more direct and sort of smarter in the touches that we have with our customers and prospects every day. So that is something that we're focused on. We've just gone through a bit of a restructure in that organization as well, some more to follow, but we will be using data more smartly in the future.

Michael J. Cyprys*Morgan Stanley & Co. LLC*

Q

Is there anything on the spend side as you're thinking about that that would be additive to the run rate in order to get there, and just anything you could flush out in terms of what specifically this makes in terms of trying to monetize that opportunities set?

Karl A. Roessner*Chief Executive Officer & Director*

A

No. We look forward and we're doing a lot of our planning processes right now. I think everything is going to be within that operating margin framework.

Michael J. Cyprys*Morgan Stanley & Co. LLC*

Q

Got it. If I can just ask one last one here, on the managed accounts, I think you mentioned targeting about \$6B or so in managed accounts. Just curious how you're thinking about what sort of those products would be? Is it just growing the robo that you launched recently? Is it anything else? If you could just flesh out how you're thinking about growing the managed accounts and the strategy around that?

Karl A. Roessner*Chief Executive Officer & Director*

A

So, it's really our existing suite of products, right? We have our managed accounts; we have the robo offering that's just out there. And even this past quarter, we saw when we put a little bit of marketing juice behind it that we did have some decent returns on it right, to grow it to \$175mm from, I don't know, approximately \$100mm last quarter. So, we're getting there, but I think in terms of the retirement or the longer term investing assets, what we really need to do is get our name out there, right, make sure that even our own customers are aware that we offer those products, because we have a nice suite of products to go with.

So, it's really more of a – goes hand in hand with what Rodger is talking about, with getting better at marketing and putting it out there, but it would be the existing suite. There're no plans right now to expand.

Devin P. Ryan*JMP Securities LLC*

Q

So, you've spoken about being disciplined financially, if you look at inorganic growth, and I think there would be some scarcity in certain areas of the business that you could look at. So, you called OptionsHouse a full price and so, just trying to think about kind of that vs. the comment that you would be financially disciplined if you look to do something. Is there a hurdle rate we should think about in a deal, or I guess what makes a deal good financially?

Karl A. Roessner*Chief Executive Officer & Director*

A

Well, before I turn it over to Mike, I would just say, we absolutely said that we paid a full price, but I believe we paid a fair price and we do expect to get quite a bit of value out of that acquisition for our shareholders and for us. So, we were very disciplined in that one as well, but Mike, do you want to add some color on it?

Michael A. Pizzi*Chief Financial Officer & Executive Vice President*

A

Sure. I mean, the most important criteria is going to be return on invested capital. And we're going to look for return on invested capital that are higher than our cost of capital. With that in mind, the relative size or riskiness of the acquisition means that that spread needs to be probably larger for a riskier acquisition than for one that has less risk, but they have to achieve a rate above the cost of capital.

Additionally, earnings accretion is important. Now that will depend on deal size, and it'll depend on a lot of other factors in the deal, but it's going to be important that we have meaningful accretion relative to the size of the deal.

And then lastly, just looking at the accretion of overall ROE, and making sure that we are building a return on equity of the pro forma combined entity. These are the metrics that we're going to look at carefully and hold any deal to in terms of providing value to shareholders.

Devin P. Ryan

JMP Securities LLC

Q

Okay. That's helpful. And then just maybe coming back to brokerage growth, I just want to dig in a little bit more and thinking about closing that gap with peers. I mean, is catching up really in areas where peers are growing faster or is it E*TRADE going in a different path over time? And just really trying to think about kind of the buckets that you laid out on trading and deepening customer engagement. I mean, we touched on marketing, but what other specific initiatives are there that really you think can move the needle?

Karl A. Roessner

Chief Executive Officer & Director

A

So, look, Devin, first and foremost, I think it's getting OptionsHouse fully integrated, right? Being able to offer the number one options trading platform to all of E*TRADE's customers is a huge thing. So, we're pushing pretty heavily on getting that done and wrapped up, so that folks have access to that. Second thing is really focusing on being a trading firm again, right? Focusing on our active trader base and on the folks who want to interact with us on a daily basis, and making sure that we're providing them the tools to do so, right? As E*TRADE, we always had a fantastic interface in E*TRADE Pro, rolling out to our customers that they could interact with, and we've lost a bit of luster on that and we're putting it back, right?

So, I think catching up is not enough for this management team, sort of where we are. We'd like to catch up and exceed. So, working on the technology front, making sure that we're keeping current with all of the products and services that are out there and making sure that we're offering the best possible interaction on the derivatives trading side, right, whether that be options or futures. We'll get there very quickly if we can integrate this well. So, it's really getting back to our roots, but catching up alone isn't just going to do it for us.

Devin P. Ryan

JMP Securities LLC

Q

Got it. Very helpful. Just last quick one here. Any way to get October DARTs, just so we can start to think about the contribution from OptionsHouse?

Michael A. Pizzi

Chief Financial Officer & Executive Vice President

A

We're off to a little bit slower of a start, but we'll give those metrics later, but right now we're not giving out the quarter-to-date metrics.

Brian Bedell

Deutsche Bank Securities, Inc.

Q

Maybe just a clarification question, Mike, on the balance sheet strategy, the \$56B. Just to clarify, that's moving the \$11B of off-balance sheet deposits and then would that – if you'd just explain, is the total balance sheet size, is that correct? And then what would the earnings assets be?

Michael A. Pizzi

Chief Financial Officer & Executive Vice President

A

Yeah. \$56B is the total balance sheet size. So that's not all \$11B. You can back in to how much that's going to be of the \$11B. The growth will continue past that point, that's what our expectation is by Q2. The limiting factor is capital and the 7% consolidated ratio in terms of how fast we deploy, but it's also helpful to deploy in a thoughtful manner over time, building the securities balances in a way to be adding the value that we have been, as we select securities. So, we think that's really the appropriate rate for the build out.

Brian Bedell

Deutsche Bank Securities, Inc.

Q

And so that would convert to an earning asset balance of around – is that around \$51B then or \$52B?

Michael A. Pizzi

Chief Financial Officer & Executive Vice President

A

We're not really giving the specificity because that will depend on sort of the date at which we actually break, but we do believe in H1 we'll get there and end at about \$56mm.

Brian Bedell

Deutsche Bank Securities, Inc.

Q

But, yeah, again, for the total, not the earning?

Michael A. Pizzi

Chief Financial Officer & Executive Vice President

A

For the total.

Brian Bedell

Deutsche Bank Securities, Inc.

Q

Okay. Great. And then just maybe, Rodger, another question on M&A. And I guess, as the board thought about this new path, have you also thought about the implications from the Department of Labor rule and how that's impacting the warehouses, and how bank's strategies may change from brokerage to fee-based in the role that an online broker could play, the new role an online broker could play in that dynamic? And would it make more sense for E*Trade to be a part of a larger broker platform?

Rodger A. Lawson

Executive Chairman

A

Well, it's a very interesting question. And we look at it multiple ways. But sometimes the cup is half full, sometimes the cup is half empty, depending on which day and what are the latest information we've got. We're all there, Brian. I think, for, I mean, obviously we understand the problems which it represents in terms of the retirement business. But I think, overall, it is an opportunity for the industry in the broadest sense of the work, and

I think we view there's an opportunity for ourselves whether buy ourselves or maybe gives us impetus to examination of the RAA channel and what that could represent for us in one form or another.

And then obviously, the RAA channel itself is going to be impacted. But net-net, even with the good days and bad days in terms of how we try to understand it, I think we view it as a net plus in terms of an opportunity for us. But Karl spent more time looking at it, what do you think, Karl?

Karl A. Roessner

Chief Executive Officer & Director

A

So, I think, the deal overall at its course, it makes sense, right? Because we should always be operating in the best interest of our customers at all times, so it makes a lot of sense to me. There're still a lot of unsettled pieces and a lot of uncertainty around DOL right now. So, I think answering that question is a bit difficult in a vacuum. So, I'd like to see how it plays out come April and see what the first lawsuits are before we actually sort of move forward with it.

Vincent Hung

Autonomous Research US LP

Q

So, I believe that you used Broadridge for some back office processing. And there is a change of control agreements where an acquirer that has an in-house capability would have to pay perhaps an onerous fee to exit it, whereas if you were to come together with a company that has a Broadridge agreement in place too, you would perhaps be able to extract meaningful synergies from that. So, can you give us some color around this Broadridge agreement and how big a factor it is when it comes to contemplating any potential deal?

Karl A. Roessner

Chief Executive Officer & Director

A

So, I'd have to sort of look at the actual agreements, right? We've had agreements in place with Broadridge for quite some time and the service level agreements and other pieces are quite voluminous. I don't know the exact answer to your question. Mike, I don't see it.

Michael A. Pizzi

Chief Financial Officer & Executive Vice President

A

Yeah. Look, Broadridge is a very important partner to us. And our most important vendor doing all of our books and records and processing for our customers. Again, you are correct that this contract do have provisions that control movement, but in relation to your question, it's not going to be meaningful. It's just something you would asses in costs in any combination, but it's not going to be a meaningful factor in any decision.

Daniel Thomas Fannon

Jefferies LLC

Q

I guess, just with the change in strategy and the focus on growth, is the appetite to exit the legacy loan portfolio through a sale changed at all?

Michael A. Pizzi

Chief Financial Officer & Executive Vice President

A

Right now, when we look at the legacy loan portfolio, there is really not a transaction that would add value. In fact, I would say the transact would be value disruptive. The portfolio is performing quite well. Loans, as they convert from I/O to amortizing, pickup pretty significantly in overall price. And we've been trying as best possible to

manage the expense of administrating the portfolio. So, while I can't say what it means in the long run for the foreseeable future, we intend to hold the portfolio.

Doug R. Mewhirter

SunTrust Robinson Humphrey, Inc.

Q

Just a quick question. Your customer cash program, I understand you're bringing a lot of money from off-balance sheet to your deposit base. So, for customers that you acquire organically and new customer signs up through E*TRADE, are all of their deposits, their incremental cash going to deposits by default or do you still have to sort of shunt some of that off-balance sheet to manage the growth of your balance sheet?

Michael A. Pizzi

Chief Financial Officer & Executive Vice President

A

Well, any customer that opens up an account that is in the extended sweep deposit insurance program what immediately be placed into the program. And if you think about how that program is going to work, our bank is going to be one of many banks in that program, which allows us to take as much the deposit on balance sheet or off. So it's not specific at a customer level, it's an overall program of what our bankers want.

That said, it's not really a default. Our customers have a choice of their sweep option and can choose to be a free credit or payable in the broker when they open the account. And so those – or within a government money fund. So, the customer makes the choice at the time of the account opening

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