KNIGHT CAPITAL GROUP, INC.
Form 10-Q
May 09, 2007

SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

x **QUARTERLY REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2007**

OR

¨ **TRANSITION REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934**

001-14223

Commission File Number

KNIGHT CAPITAL GROUP, INC.

(Exact name of registrant as specified in its charter)

DELAWARE

(State or other jurisdiction of incorporation or organization)

22-3689303

(I.R.S. Employer Identification Number)

545 Washington Boulevard, Jersey City, NJ 07310

(Address of principal executive offices and zip code)

Registrant s telephone number, including area code: (201) 222-9400

Indicate by check mark whether the Registrant (1) has filed all reports required to be filed by Section 13 or 15 (d) of the Securities Exchange Act of 1934 during the preceding 12 months (or for such shorter period that the Registrant was required to file such reports), and (2) has been subject to such filing requirements for the past 90 days. Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer. See definition of accelerated filer and large accelerated filer in Rule 12b-2 of the Exchange Act.

Large accelerated filer x Accelerated filer ¨ Non-accelerated filer ¨

Indicate by check mark whether the registrant is a shell company (as defined in Rule 12b-2 of the Exchange Act) Yes ¨ No x

Indicate the number of shares outstanding of each of the issuer s classes of common stock, as of the latest practicable date:

At May 9, 2007 the number of shares outstanding of the Registrant s Class A Common Stock was 103,856,220 and there were no shares outstanding of the Registrant s Class B Common Stock as of such date.

KNIGHT CAPITAL GROUP, INC.

FORM 10-Q QUARTERLY REPORT

For the Quarter Ended March 31, 2007

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Item 1. Financial Statements

KNIGHT CAPITAL GROUP, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	For the three months ended March 31, 2007	2006
Revenues		
Commissions and fees	$ 103,859,455	$ 102,643,011
Net trading revenue	61,637,081	80,039,151
Asset management fees	60,713,955	70,511,043
Interest and dividends, net	4,817,943	3,313,976
Investment income and other	10,623,229	20,687,263
Total revenues	241,651,663	277,194,444
Transaction-based expenses		
Execution and clearance fees	27,410,486	28,924,406
Soft dollar and commission recapture expense	14,536,648	18,446,324
Payments for order flow and ECN rebates	12,598,965	9,873,398
Total transaction-based expenses	54,546,099	57,244,128
Revenues, net of transaction-based expenses	187,105,564	219,950,316
Other direct expenses		
Employee compensation and benefits	102,232,892	99,556,170
Communications and data processing	8,699,226	7,638,143
Professional fees	5,489,122	6,383,123
Depreciation and amortization	5,401,780	4,407,695
Business development	3,778,832	2,122,317
Occupancy and equipment rentals	3,455,226	3,352,487
Writedown of assets and lease loss accrual		7,997,434
Other	3,332,746	6,448,370
Total other direct expenses	132,389,824	137,905,739
Income from continuing operations before income taxes	54,715,740	82,044,577
Income tax expense	21,530,028	32,912,536
Net income from continuing operations	33,185,712	49,132,041
Loss from discontinued operations, net of tax	(1,332,818)	
Net income	$ 31,852,894	$ 49,132,041
Basic earnings per share from continuing operations	$ 0.33	$ 0.49
Diluted earnings per share from continuing operations	$ 0.32	$ 0.47

Basic and diluted earnings per share from discontinued operations	$	(0.01)	$	
Basic earnings per share	$	0.32	$	0.49
Diluted earnings per share	$	0.31	$	0.47
Shares used in computation of basic earnings per share		100,906,063		100,422,995
Shares used in computation of diluted earnings per share		104,334,956		104,129,560

The accompanying notes are an integral part of these condensed consolidated financial statements.

KNIGHT CAPITAL GROUP, INC.

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

	March 31, 2007 (Unaudited)	December 31, 2006
Assets		
Cash and cash equivalents	$ 159,232,302	$ 214,759,915
Securities owned, held at clearing brokers, at market value	711,426,136	711,774,643
Receivable from brokers and dealers	351,754,733	372,897,376
Asset management fees receivable	46,927,428	112,204,064
Investment in Deephaven sponsored funds	195,366,563	187,573,291
Fixed assets and leasehold improvements, at cost, less accumulated depreciation and amortization	64,276,103	66,449,617
Strategic investments	45,936,798	49,436,605
Goodwill	133,072,889	133,042,889
Intangible assets, less accumulated amortization	62,253,105	63,701,006
Other assets	192,576,738	116,374,310
Total assets	$ 1,962,822,795	$ 2,028,213,716
Liabilities and Stockholders Equity		
Liabilities		
Securities sold, not yet purchased, at market value	$ 690,321,227	$ 693,071,230
Payable to brokers and dealers	53,445,355	47,852,721
Accrued compensation expense	143,068,776	227,846,699
Accrued expenses and other liabilities	108,228,744	96,956,122
Total liabilities	995,064,102	1,065,726,772
Stockholders equity		
Class A Common Stock, $0.01 par value;		
Shares authorized: 500,000,000 at March 31, 2007 and December 31, 2006; Shares issued: 148,912,707 at March 31, 2007 and 144,958,749 at December 31, 2006; Shares outstanding: 104,621,212 at March 31, 2007 and 103,660,303 at December 31, 2006	1,489,127	1,449,588
Additional paid-in capital	544,601,895	519,790,132
Retained earnings	843,712,219	811,859,325
Treasury stock, at cost; 44,291,495 shares at March 31, 2007 and 41,298,446 shares at December 31, 2006	(422,044,548)	(370,612,101)
Total stockholders equity	967,758,693	962,486,944
Total liabilities and stockholders equity	$ 1,962,822,795	$ 2,028,213,716

The accompanying notes are an integral part of these condensed consolidated financial statements.

KNIGHT CAPITAL GROUP, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	For the three months ended March 31, 2007	2006
Cash flows from operating activities		
Net income	$ 31,852,894	$ 49,132,041
Loss from discontinued operations, net of tax	(1,332,818)	
Income from continuing operations, net of tax	33,185,712	49,132,041
Adjustments to reconcile income from continuing operations, net of tax to net cash used in operating activities		
Depreciation and amortization	5,401,780	4,407,695
Stock-based compensation	7,914,022	5,660,043
Deferred rent	90,291	220,166
Writedown of assets and lease loss accrual		7,997,434
Unrealized loss on strategic investments	365,392	1,497,434
Unrealized gain on investments in Deephaven sponsored funds	(7,965,334)	(18,950,897)
Operating activities from discontinued operations	(1,332,818)	
(Increase) decrease in operating assets		
Securities owned	348,507	(141,260,618)
Receivable from brokers and dealers	21,142,643	(143,869,138)
Asset management fees receivable	66,553,751	
Other assets	(77,307,481)	(39,452,182)
Increase (decrease) in operating liabilities		
Securities sold, not yet purchased	(2,750,003)	159,858,302
Payable to brokers and dealers	5,592,634	86,707,607
Accrued compensation expense	(84,777,923)	(19,682,664)
Accrued expenses and other liabilities	11,182,331	11,403,966
Net cash used in operating activities	(22,356,496)	(36,330,811)
Cash flows from investing activities		
Purchases of fixed assets and leasehold improvements	(1,780,365)	(2,806,688)
Redemption of Deephaven sponsored funds		22,610,000
Proceeds from strategic investments	5,534,415	
Purchases of strategic investments	(2,400,000)	(4,250,000)
Purchases of businesses, net of cash acquired	(30,000)	
Contingency payment on purchase of business		(1,500,000)
Net cash provided by investing activities	1,324,050	14,053,312
Cash flows from financing activities		
Stock options exercised	9,934,434	2,768,339
Income tax benefit on stock awards exercised	7,002,846	1,248,313
Cost of common stock repurchased	(51,432,447)	(2,542,050)
Net cash (used in) provided by financing activities	(34,495,167)	1,474,602
Decrease in cash and cash equivalents	(55,527,613)	(20,802,897)
Cash and cash equivalents at beginning of period	214,759,915	230,591,067
Cash and cash equivalents at end of period	$ 159,232,302	$ 209,788,170

Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 27,348	$ 35,578
Cash paid for income taxes	$ 28,638,096	$ 23,869,294

The accompanying notes are an integral part of these condensed consolidated financial statements.

KNIGHT CAPITAL GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2007

(Unaudited)

1. Organization and Description of the Business

Knight Capital Group, Inc. and its subsidiaries (the Company) have two operating business segments, Asset Management and Global Markets, as well as a Corporate segment. As of March 31, 2007, the Company s operating business segments from continuing operations comprised the following operating subsidiaries:

Asset Management

Deephaven Capital Management LLC (Deephaven) is the registered investment adviser to and sponsor of the Deephaven investment funds (the Deephaven Funds). In addition to being registered as an Investment Adviser with the Securities and Exchange Commission (SEC or Commission), Deephaven is also registered with the Commodity Futures Trading Commission (CFTC) as a commodity pool operator and a commodity trading adviser, and is a member of the National Futures Association (NFA). Due to the nature of Deephaven s investor base, however, Deephaven is not registered as either a Futures Commission Merchant or Introducing Broker with the CFTC/NFA and is exempt from many of the CFTC/NFA regulations. Deephaven also has a U.K. registered investment adviser subsidiary, which is regulated by the Financial Services Authority (FSA) in the U.K., and a Hong Kong registered investment adviser subsidiary, which is regulated by the Hong Kong Securities and Futures Commission.

Global Markets

Knight Equity Markets, L.P. (KEM) operates as a market-maker in over-the-counter (OTC) equity securities, primarily those traded in the Nasdaq Stock Market and on the OTC Bulletin Board. KEM also operates the Company s primary domestic institutional sales business. Donaldson & Co., a division of KEM, offers soft dollar and commission recapture services. KEM is a broker-dealer registered with the SEC and is a member of the Nasdaq Stock Exchange (Nasdaq), National Association of Securities Dealers, Inc. (NASD), the International Securities Exchange, LLC, the National Stock Exchange and the NFA.

Knight Capital Markets LLC (KCM) primarily operates as a market-maker in the Nasdaq Intermarket, the over-the-counter market for New York Stock Exchange (NYSE) and American Stock Exchange (AMEX) listed securities. KCM is a broker-dealer registered with the SEC and is a member of Nasdaq and the NASD.

Knight Equity Markets International Limited (KEMIL) is a U.K. registered broker-dealer that provides execution services for institutional and broker-dealer clients in U.S., European and international equities. KEMIL is authorized and regulated by the FSA and is a member of the London Stock Exchange, Deutsche Börse AG, Euronext N.V. (incorporating Euronext Amsterdam, Euronext Brussels, Euronext Lisbon and Euronext Paris), Borsa Italiana, OMX (incorporating the Copenhagen Stock Exchange, Helsinki Stock Exchange and Stockholm Stock Exchange), Oslo Børs and virt-x.

Direct Trading Institutional, L.P. (Direct Trading) provides institutions with direct market access trading through Knight Direct, an advanced electronic platform. Direct Trading is a broker-dealer registered with the SEC and is a member of Nasdaq, the NASD and the NFA.

Direct Edge ECN LLC (Direct Edge) operates as an electronic communications network (ECN). Direct Edge is a liquidity destination offering the ability to match trades in Nasdaq Global Market, Nasdaq Global Select Market, Nasdaq Capital Market and NYSE and AMEX listed securities by displaying orders in the NASD Alternative Display Facility. Direct Edge is a broker-dealer registered with the SEC and is a member of Nasdaq, the NASD, the National Stock Exchange, Chicago Stock Exchange, CBOE Stock Exchange, Boston Stock Exchange and NYSE Arca, Inc.

Hotspot FX, Inc. and its subsidiaries (Hotspot) provide institutions, dealers and retail clients with spot foreign exchange executions through an advanced, fully electronic platform. Hotspot was acquired by the Company in April 2006. One Hotspot subsidiary is regulated by the FSA and another Hotspot subsidiary is a Futures Commission Merchant registered with the CFTC and is a member of the NFA.

ValuBond Securities, Inc. (ValuBond) provides electronic access and trade execution products for the fixed income market. ValuBond was acquired by the Company in October 2006. ValuBond is registered with the SEC and is a member of the NASD and the Municipal Securities Rulemaking Board (MSRB).

The Corporate segment includes all corporate overhead expenses and investment income earned on strategic investments and the corporate investment in the Deephaven Funds. Corporate overhead expenses primarily consist of compensation for certain senior executives and other individuals employed at the corporate holding company, legal and other professional expenses related to corporate matters, directors fees, investor and public relations expenses and directors and officers insurance.

Discontinued Operations

The Company completed the sale of its Derivative Markets business to Citigroup Financial Products Inc. (Citigroup) for $237 million in December of 2004. Costs associated with the Derivative Markets segment have been included within discontinued operations for the three months ended March 31, 2007. For a further discussion of the sale of the Company s Derivative Markets business and its associated accounting treatment, see Footnote 9 Discontinued Operations.

2. Significant Accounting Policies

Basis of consolidation and form of presentation

The accompanying unaudited consolidated financial statements include the accounts of the Company and its subsidiaries and, in the opinion of management, reflect all adjustments, consisting only of normal recurring adjustments, necessary for a fair statement of the results for the interim period. All significant intercompany transactions and balances within continuing operations have been eliminated. Certain footnote disclosures normally included in financial statements prepared in accordance with generally accepted accounting principles (GAAP) have been condensed or omitted pursuant to SEC rules and regulations, although the Company believes that the disclosures are adequate to make the information presented not misleading. The nature of the Company s business is such that the results of an interim period are not necessarily indicative of the results for the full year. These unaudited consolidated financial statements should be read in conjunction with the financial statements and notes thereto included in the Company s Annual Report on Form 10-K for the year ended December 31, 2006 as filed with the SEC.

Certain prior period amounts have been reclassified to conform to the current period presentation.

Cash and cash equivalents

Cash and cash equivalents include money market accounts, which are payable on demand, and short-term investments with an original maturity of less than 90 days. The carrying amount of such cash equivalents approximates their fair value due to the short-term nature of these instruments.

Market making and sales activities

Securities owned and securities sold, not yet purchased, which primarily consist of listed and OTC equities, are carried at market value and are recorded on a trade date basis. Net trading revenue (trading gains, net of trading losses) and commissions (which includes commission equivalents earned on institutional client orders) and related expenses are also recorded on a trade date basis.

Payments for order flow and ECN rebates represent payments to broker-dealer clients, in the normal course of business, for directing their order flow in U.S. equities to the Company, and rebates for providing liquidity to Direct Edge. Soft dollar and commission recapture expense represents payments to institutions in connection with soft dollar and commission recapture programs. The Company s clearing agreements call for payment or receipt of interest income, net of interest expense, for facilitating the settlement and financing of securities transactions.

Asset management fees

Deephaven earns asset management fees for sponsoring and managing the Deephaven Funds. These fees are recorded monthly as earned and are calculated as a percentage of each Deephaven Funds monthly net assets, plus a percentage of a new high net asset value (the Incentive Allocation Fee), as defined in the applicable private placement offering memorandum, for any six month performance period ended June 30th or December 31st. A new high net asset value is defined as the amount by which the net asset value of the particular Deephaven fund exceeds the greater of either the highest previous net asset value in that Deephaven fund or the net asset value at the time each investor made a purchase. The Incentive Allocation Fee may increase or decrease during the year based on the performance of the Deephaven Funds.

Estimated fair value of financial instruments

The market value of securities owned and securities sold, not yet purchased is estimated using market quotations available from major securities exchanges, clearing brokers and dealers. Management estimates that the fair values of other financial instruments recognized on the Consolidated Statements of Financial Condition (including receivables, payables and accrued expenses) approximate their carrying values, as such financial instruments are short-term in nature, bear interest at current market rates or are subject to frequent repricing.

Goodwill and intangible assets

The Company applies the provisions of Statement of Financial Accounting Standards (SFAS) No. 142 *Goodwill and Other Intangible Assets,* which requires that goodwill and intangible assets with an indefinite useful life no longer be amortized, but instead, be tested for impairment annually or when an event occurs or circumstances change that signify the existence of impairment. Other intangible assets are amortized on a straight line basis over their useful lives.

Strategic investments

Strategic investments include non-controlling equity ownership interests in financial services-related businesses and are accounted for under the equity method at cost or at fair value. The equity method of accounting is used for investments in limited partnerships and limited liability companies that are held by the Company or any of its non-broker-dealer subsidiaries. Investments in corporations by such non-broker-dealers are held at amortized cost. The fair value of investments recorded in the Company s broker-dealer subsidiaries, for which a quoted market or dealer price is not available for the size of the Company s investment, is based on management s estimate. Among the factors considered by management in determining the fair value of these investments are the cost of the investment, terms and liquidity, developments since the acquisition of the investment, the sales price of recently issued securities, the financial condition and operating results of the issuer, earnings trends and consistency of operating cash flows, the long-term business potential of the issuer, the quoted market price of securities with similar quality and yield that are publicly traded, and other factors generally pertinent to the valuation of investments. The fair value of these investments is subject to a high degree of volatility and may be susceptible to significant fluctuations in the near term.

Investments classified as available-for-sale are reported at fair value with unrealized gains and losses excluded from earnings and reported in Accumulated other comprehensive income, net of tax within Stockholders equity on the Consolidated Statements of Financial Condition.

Strategic investments are reviewed on an ongoing basis to ensure that the carrying values of the investments have not been impaired. If the Company assesses that an impairment loss on a strategic investment has occurred due to a decline in fair value or other market conditions, the investment is written down to its estimated impaired value.

Treasury stock

The Company records its purchases of treasury stock at cost as a separate component of Stockholders equity. The Company obtains treasury stock through purchases in the open market or through privately negotiated transactions.

Foreign currencies

The functional currency of the Company s foreign subsidiaries is the U.S. dollar. Assets and liabilities in foreign currencies are translated into U.S. dollars using current exchange rates at the date of the Consolidated Statements of Financial Condition. Revenues and expenses are translated at average rates during the periods. Gains or losses resulting from foreign currency transactions are included in Investment income and other on the Company s Consolidated Statements of Operations.

Depreciation, amortization and occupancy

Fixed assets are being depreciated on a straight-line basis over their estimated useful lives of three to seven years. Leasehold improvements are being amortized on a straight-line basis over the shorter of the life of the related office lease or the expected useful life of the assets. The Company records rent expense on a straight-line basis over the lives of the leases. The Company capitalizes certain costs associated with the acquisition or development of internal-use software and amortizes the software over its estimated useful life of three years, commencing at the time the software is placed in service.

Writedown of fixed assets

Writedowns of fixed assets are recognized when it is determined that the fixed assets are impaired. The amount of the impairment writedown is determined by the difference between the carrying amount and the estimated fair value of the fixed asset. In determining the impairment, an estimated fair value is obtained through research and inquiry of the market. Fixed assets are reviewed for impairment on a periodic basis.

Lease loss accrual

It is the Company s policy to identify excess real estate capacity and where applicable, accrue for such future costs. In determining the accrual, a nominal cash flow analysis is performed for lease losses initiated prior to December 31, 2002, the effective date of SFAS No. 146 *Accounting for Costs Associated with Exit or Disposal Activities,* and costs related to the excess capacity are accrued. For lease losses initiated after December 31, 2002, the Company s policy is to accrue future costs related to excess capacity using a discounted cash flow analysis.

Income taxes

The Company records deferred tax assets and liabilities for the expected future tax consequences of temporary differences between the financial reporting and tax bases of assets and liabilities and measures them using the enacted tax rates and laws that will be in effect when such differences are expected to reverse. The Company evaluates the recoverability of future tax deductions by assessing the adequacy of future expected taxable income from all sources, including reversal of temporary differences and forecasted operating earnings. Net deferred tax assets and liabilities are included in Other assets and Accrued expenses and other liabilities, respectively, on the Consolidated Statements of Financial Condition.

On January 1, 2007 the Company adopted Financial Standards Accounting Board Interpretation No. 48 Accounting for Uncertainty in Income Taxes (FIN 48). The Company recognized no material adjustment in the liability for unrecognized income tax benefits as a result of the implementation of FIN 48.

Stock-based compensation

On January 1, 2006, the Company adopted SFAS No. 123-R, *Share-Based Payment* (SFAS No. 123-R), using the modified prospective method. Under SFAS No. 123-R, the grant date fair values of stock-based employee awards that require future service are amortized over the relevant service period.

Upon the adoption of SFAS No. 123-R, the Company changed its expense attribution method for options. For option awards granted subsequent to the adoption of SFAS No. 123-R, compensation cost is recognized on a straight-line basis over the requisite service period for the entire award, which is the same methodology that the Company uses to account for restricted share awards. For unvested option awards granted prior to the adoption of SFAS No. 123-R, the Company continues to recognize compensation cost using a graded-vesting method (as it had on a pro-forma basis previously). The graded-vesting method recognizes compensation cost separately for each vesting tranche.

SFAS No. 123-R requires expected forfeitures to be considered in determining stock-based employee compensation expense. For all periods presented, the Company recorded a benefit for expected forfeitures on all outstanding stock-based awards.

For stock-based payments issued after the adoption of SFAS No. 123-R, the Company applies a non-substantive vesting period approach whereby the expense is accelerated for those employees and directors that receive awards and are eligible to retire prior to the award vesting. Prior to the adoption of SFAS No. 123-R, the Company applied a nominal vesting approach for employee stock-based compensation awards with retirement eligible provisions. Under the nominal vesting approach, the Company recognized actual and pro-forma compensation cost over the vesting period and, if the employee retired before the end of the vesting period, the Company recognized any remaining unrecognized compensation cost at the date of retirement. The impact of this change in the vesting period approach did not have a material impact on the results of operations for the periods presented herein.

Other

The preparation of financial statements in conformity with GAAP requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the date of the financial statements and the reported amounts of revenues and expenses during the reporting period. Actual results may differ from those estimates.

3. Securities Owned and Securities Sold, Not Yet Purchased

Securities owned and securities sold, not yet purchased are carried at market value and consist of the following (in millions):

	March 31, 2007	December 31, 2006
Securities owned:		
Equities	$ 702.5	$ 703.0
U.S. government obligations	8.9	8.8
	$ 711.4	$ 711.8
Securities sold, not yet purchased:		
Equities	$ 690.3	$ 693.1
	$ 690.3	$ 693.1

4. Receivable from and Payable to Brokers and Dealers

Amounts receivable from and payable to brokers and dealers consist of the following (in millions):

	March 31, 2007	December 31, 2006
Receivable:		
Clearing brokers and other	$ 278.8	$ 305.3
Securities failed to deliver	64.0	42.3
Deposits for securities borrowed	8.9	25.2
	$ 351.8	$ 372.9
Payable:		
Securities failed to receive	$ 43.0	$ 34.4
Clearing brokers and other	10.5	13.4
	$ 53.4	$ 47.9

5. Goodwill and Intangible Assets

Goodwill and intangible assets with indefinite useful lives are tested for impairment annually or when an event occurs or circumstances change that signify the existence of impairment. As part of the test for impairment, the Company considers the profitability of the respective segment or reporting unit, an assessment of the fair value of the respective segment or reporting unit as well as the overall market value of the Company compared to its net book value. In June 2006, the Company tested for the impairment of goodwill and intangible assets and concluded that there was no impairment.

The goodwill balance of $133.1 million at March 31, 2007 relates to the Global Markets business segment. Goodwill is net of accumulated amortization of $21.9 million recorded through December 31, 2001, the effective date the Company adopted SFAS No. 142. Goodwill primarily represents the Company s purchases of the businesses now operating as KCM, Direct Trading, Direct Edge, Hotspot, Donaldson and ValuBond.

The Company had intangible assets, net of accumulated amortization, of $62.3 million and $63.7 million at March 31, 2007 and December 31, 2006, respectively, all included within the Global Markets business segment. Intangible assets decreased by $1.4 million during the three months ended March 31, 2007 due to amortization expense. Intangible assets primarily represent client relationships and are being amortized over their remaining useful lives, the majority of which have been determined to range from eight to thirty years.

The Company recorded amortization expense, related to its intangible assets of $1.4 million and $735,000 for the three months ended March 31, 2007 and 2006, respectively. The estimated amortization expense relating to the intangible assets for each of the next five years approximates $4.3 million in 2007, $5.7 million in 2008, $5.1 million in 2009, and $4.9 million in each of 2010 and 2011.

The chart below summarizes the activity of the Company s Goodwill and Intangible assets, net of accumulated amortization, from continuing operations, for the three months ended March 31, 2007 (in millions):

	Goodwill	Intangible Assets
Balance at January 1, 2006	$ 47.7	$ 29.8
Contingent payments on purchases of businesses	1.5	
Amortization expense		(0.7)
Balance at March 31, 2006	$ 49.2	$ 29.0
Balance at January 1, 2007	$ 133.1	$ 63.7
Amortization expense		(1.4)

Balance at March 31, 2007	$ 133.1	$ 62.3

6. Investment in Deephaven Sponsored Funds and Strategic Investments
The Company s wholly-owned subsidiary, Deephaven, is the registered investment adviser and sponsor of the Deephaven Funds, which engage in various trading strategies involving equities, debt instruments and derivatives. The underlying investments in the Deephaven Funds are carried at market value. Of the $3.6 billion and $4.2 billion of assets under management in the Deephaven Funds as of March 31, 2007 and December 31, 2006, respectively, the Company had corporate investments of $195.4 million and $187.6 million, respectively. Other assets on the Consolidated Statements of Financial Condition at March 31, 2007 and December 31, 2006 included $52.6 million and $31.6 million, respectively, of investments in the Deephaven Funds related to employee deferred compensation plans. Certain officers, directors and employees of the Company held direct investments of approximately $9.5 million and $6.2 million in the Deephaven Funds, in the aggregate, as of March 31, 2007 and December 31, 2006, respectively.

Included in Investment income and other on the Company s Consolidated Statements of Operations is income from the Company s corporate investments in the Deephaven Funds of $8.0 million and $19.0 million for the three months ended March 31, 2007 and 2006, respectively.

In connection with the sale of the Derivative Markets business in December 2004 (see Footnote 9, Discontinued Operations) and in light of the reorganization of the Company s business segments, the Company transferred its investment in the International Securities Exchange, Inc. (ISE), which was previously held by its broker-dealer subsidiaries, to a corporate investment holding company. During the first quarter of 2005, this equity investment became marketable and, accordingly, was accounted for as an equity security under SFAS No. 115 *Accounting for Certain Investments in Debt and Equity Securities* and was classified as an available-for-sale security. The Company sold all of its remaining shares of the ISE in the last nine months of 2006 for a pre-tax gain of $30.1 million. As of March 31, 2006, the Company owned 743,000 shares of common stock in the ISE, which had an aggregate fair value and amortized cost of $30.9 million and $2.9 million, respectively.

7. Significant Clients
The Company considers significant clients to be those clients who account for 10% or more of the total U.S. equity dollar value traded by the Company during the period. No clients accounted for more than 10% of the Company s U.S. equity dollar value traded during the three months ended March 31, 2007. One client accounted for approximately 11.4% of the Company s U.S. equity dollar value traded during the three months ended March 31, 2006.

No investor accounted for more than 10% of the Deephaven Funds asset under management as of March 31, 2007. One investor accounted for 10.2% of the Deephaven Funds asset under management as of March 31, 2006.

8. Writedown of Assets and Lease Loss Accrual
There were no charges for Writedown of assets and lease loss accrual during the three months ended March 31, 2007.

The Writedown of assets and lease loss accrual for the three months ended March 31, 2006 were $8.0 million. The charge primarily related to costs associated with excess real estate capacity at the Company s 545 Washington Boulevard facility in Jersey City, N.J.

9. Discontinued Operations
The Company completed the sale of its Derivative Markets business to Citigroup for $237 million in cash in December 2004. In accordance with SFAS No. 144, the results of the Derivative Markets business segment, the

revenues and expenses associated with these businesses as well as all costs associated with the sale transaction have been included in Loss from discontinued operations, net of tax on the Consolidated Statements of Operations for all periods presented. As described in Footnote 11 Regulatory Charges and Related Matters , during the first quarter of 2007, the Company recorded a charge of $1.3 million, net of taxes, related to a regulatory matter involving the Derivative Markets segment.

		Three months ending March 31, 2007
Revenues	$	
Pre-tax loss from discontinued operations	$	(2.0)
Income tax benefit		0.6
Loss from discontinued operations, net of tax	$	(1.3)

10. Commitments and Contingent Liabilities

In the ordinary course of business, the nature of the Company s business subjects it to claims, lawsuits, regulatory examinations and other proceedings. We are subject to several of these matters at the present time. The results of these matters cannot be predicted with certainty. There can be no assurance that these matters will not have a material adverse effect on the Company s results of operations in any future period and a material judgment could have a material adverse impact on the Company s financial condition and results of operations. However, it is the opinion of management, after consultation with legal counsel that, based on information currently available, the ultimate outcome of these matters will not have a material adverse impact on the business, financial condition or operating results of the Company although they might be material to the operating results for any particular period, depending, in part, upon operating results for that period.

The Company leases office space under noncancelable operating leases. Certain office leases contain fixed escalation clauses. Rental expense from continuing operations under the office leases was $2.2 million and $2.1 million for the three months ended March 31, 2007 and 2006, respectively and is included in Occupancy and equipment rentals on the Consolidated Statements of Operations.

The Company leases certain computer and other equipment under noncancelable operating leases and has entered into guaranteed employment contracts with certain of its employees. As of March 31, 2007, future minimum rental commitments under all noncancelable office, computer and equipment leases (Operating Leases), and guaranteed employment contracts longer than one year (Other Obligations) were as follows (in millions):

	Operating Leases		Other Obligations		Total
Nine months ending December 31, 2007	$	8.5	$	41.2	$ 49.7
Year ending December 31, 2008		10.9		32.0	42.9
Year ending December 31, 2009		10.4		14.9	25.3
Year ending December 31, 2010		9.8			9.8
Year ending December 31, 2011		10.2			10.2
Thereafter through October 31, 2021		101.9			101.9
	$	151.7	$	88.1	$ 239.8

During the normal course of business, the Company collateralizes certain leases or other contractual obligations through letters of credit or segregated funds held in escrow accounts. As of March 31, 2007, the Company has provided a letter of credit for $6.0 million, collateralized by U.S. Treasury Bills, as a guarantee for one of the Company s lease obligations.

In 2003, the Company entered into long-term employment contracts with certain senior managers of Deephaven. These employment agreements, which became effective on January 1, 2004, had a three-year term which expired on December 31, 2006. The agreements provided for profit sharing bonuses based on the financial performance of Deephaven, which, for 2005 and 2006, represented 50% of pre-tax earnings prior to the profit-sharing bonuses. The employment agreements included an option for renewal by the Deephaven managers through 2009 under the identical financial terms; however, the renewal option was not exercised. Pursuant to the terms of a simultaneously executed option agreement between the Company and these senior Deephaven managers, in the event of a change of control of the Company during the initial three-year employment term, the Deephaven senior managers had the option to obtain a 51% interest in Deephaven in exchange for the termination of their employment contracts and associated profit-sharing bonuses. As the Company did not experience a change of control during the term of these employment contracts, this option expired.

In December 2006, the Company entered into new long-term employment agreements with three senior managers of Deephaven (the Deephaven Managers), two of whom were parties to the 2003 agreements. The new agreements, which became effective on January 1, 2007, are for three-year terms and include a right of renewal by the Deephaven Managers through 2012 under certain circumstances. The new employment agreements provide profit-sharing bonuses based on the financial performance of Deephaven. According to the terms of the contracts, the Deephaven Managers will receive 50% of the first $60 million, and 75% thereafter, of pre-tax earnings prior to the profit-sharing bonuses. The Deephaven Managers also received one million shares of Knight restricted common stock, which vest ratably over three years.

Effective January 1, 2007, the Deephaven Managers were also granted an option (the Option), exercisable after January 1, 2008 and until December 31, 2012, and conditioned on meeting certain requirements, to obtain a 49% interest in Deephaven (or a new limited liability company to which the Company s interests in Deephaven would be contributed) in exchange for the termination of their new employment agreements and associated profit-sharing bonuses. The agreement also provides that in the event of a change of control of the Company following January 1, 2007 and prior to December 31, 2012, the Deephaven Managers would have the option (the Change of Control Option), in exchange for the termination of their new employment contracts and associated profit-sharing bonuses, to obtain a 51% interest in Deephaven or, if the Option has already been exercised, to increase their 49% interest resulting from the exercise of the Option by an additional 2%. Following any exercise of the Option or Change of Control Option by the Deephaven Managers, pre-tax earnings prior to profit sharing will be allocated between Knight and the Deephaven Managers in the same manner as under the new employment agreements. During the life of the Option, the agreements provide that the Company may not sell Deephaven without the approval of the Deephaven Managers.

11. Regulatory Charges and Related Matters

In 2006, the Company received a request from the staff of the SEC for voluntary production of certain documentation related to options activities of its former Derivative Markets business segment which, prior to its sale by the Company in December 2004, was primarily operated through Knight Financial Products LLC. The Company believes this request is part of a broader review by the staff of the SEC regarding certain trading practices in the options industry during the period 1999-2005. The Company responded to this request and is cooperating with the staff of the SEC and certain regional exchanges to resolve this matter. During the first quarter of 2007, the Company recorded a charge of $1.3 million, net of tax, relating to this matter. This charge has been reported in discontinued operations.

12. Comprehensive Income

Comprehensive income includes net income and changes in equity except those resulting from investments by, or distributions to, stockholders. Comprehensive income for the three months ended March 31, 2007 and 2006 is (in millions):

	For the three months ended March 31, 2007	2006
Net income	$ 31.9	$ 49.1
Other comprehensive income, net of tax:		
Net unrealized gains on investment securities held as available-for-sale		6.2
Total comprehensive income, net of tax	$ 31.9	$ 55.3

For the three months ended March 31, 2006, Other comprehensive income, net of tax, represents net unrealized gains on the Company s strategic investment in the ISE. The Company did not hold any available-for-sale securities during the three months ended March 31, 2007.

13. Earnings per Share

Basic earnings per common share (EPS) has been calculated by dividing net income by the weighted average shares of Class A Common Stock outstanding during each respective period. Diluted EPS reflects the potential reduction in EPS using the treasury stock method to reflect the impact of common stock equivalents if stock awards such as stock options and restricted stock were exercised or converted into common stock.

The following is a reconciliation of the numerators and denominators of the basic and diluted earnings per share computations from continuing operations for the three months ended March 31, 2007 and 2006 (in millions, except per share data):

	For the three months ended March 31, 2007		2006	
	Numerator / net income	Denominator / shares	Numerator / net income	Denominator / shares
Income and shares used in basic calculations	$ 33.2	100.9	$ 49.1	100.4
Effect of dilutive stock based awards		3.4		3.7
Income and shares used in diluted calculations	$ 33.2	104.3	$ 49.1	104.1
Basic earnings per share from continuing operations		$ 0.33		$ 0.49
Diluted earnings per share from continuing operations		$ 0.32		$ 0.47

14. Stock-Based Compensation

The Company has established the Knight Capital Group, Inc. 1998 Long Term Incentive Plan, the Knight Capital Group, Inc. 1998 Nonemployee Director Stock Option Plan, the Knight Capital Group, Inc. 2003 Equity Incentive Plan and the Knight Capital Group, Inc. 2006 Equity Incentive Plan (the 2006 Plan) (collectively, the Stock Plans). The purpose of the Stock Plans is to provide long-term incentive compensation to employees and directors of the Company. The Stock Plans are administered by the Compensation Committee of the Company s Board of Directors, and allow for the grant of options, stock appreciation rights (2006 Plan only), restricted stock and restricted stock units (collectively, the awards), as defined by the Stock Plans. The Stock Plans limit the number of awards that may be granted to a single individual as well as limit the amount of options, stock appreciation rights (2006 Plan only) or shares of restricted stock or restricted stock units that may be awarded. As of March 31, 2007, the Company has not issued any stock appreciation rights or restricted stock units.

Restricted Shares

Eligible employees receive restricted shares as a portion of their total compensation. Restricted share awards generally vest ratably over three years. The Company has the right to fully vest employees in their awards upon retirement and in certain other circumstances. Awards are otherwise canceled if employment is terminated before the end of the relevant vesting period.

The Company measures compensation cost related to restricted shares based on the market value of the Company s common stock at the date of grant, which the Stock Plans define as the average of the high and low sales price on the date prior to the grant date. For the three months ended March 31, 2007 and 2006, the Company recorded compensation expense of $6.3 million and $3.8 million, respectively, relating to restricted shares, which has been included in Employee compensation and benefits on the Consolidated Statements of Operations.

The following table summarizes restricted share activity during the three months ended March 31, 2007 (shares in millions):

	Number of Restricted Shares	**Weighted-Average Grant date Fair Value**
Outstanding at January 1, 2007	2.7	$ 11.55
Granted	2.3	18.65
Vested	(0.7)	11.43
Surrendered	(0.0)	11.10
Outstanding at March 31, 2007	4.2	$ 15.43

There is $53.5 million of unamortized compensation related to the unvested restricted shares outstanding at March 31, 2007. The cost of these unvested restricted shares is expected to be recognized over a weighted average life of 2.0 years.

Stock Options

The Company s policy is to grant options for the purchase of shares of Class A Common Stock at not less than market value, which the Stock Plans define as the average of the high and low sales price on the date prior to the grant date. Options generally vest ratably over a three or four-year period and expire on the fifth or tenth anniversary of the grant date, pursuant to the terms of the applicable option award agreement. The Company has the right to fully vest employees in their awards upon retirement and in certain other circumstances. Awards are otherwise canceled if employment is terminated before the end of the relevant vesting period. The Company s policy is to issue new shares upon share option exercises by its employees.

The fair value of each option granted is estimated as of its respective grant date using the Black-Scholes option-pricing model. Stock options granted have exercise prices equal to the market value of the Company s common stock at the date of grant as defined by the Stock Plans. The principal assumptions utilized in valuing options and the methodology for estimating such model inputs include: 1) risk-free interest rate estimate is based on the yield of U.S. zero coupon securities with a maturity equal to the expected life of the option; 2) expected volatility estimate is based on several factors including implied volatility of market-traded options on the Company s common stock on the grant date and the historical volatility of the Company s common stock; and 3) expected option life estimate is based on internal studies of historical experience and projected exercise behavior based on different employee groups and specific option characteristics, including the effect of employee terminations. Based on the results of the model, the weighted-average fair value of the stock options granted during the quarter ended March 31, 2007 and 2006 was $6.28 and $3.87 per option, respectively.

For the three months ended March 31, 2007, the Company recorded compensation expense of $1.6 million relating to options, which has been included in Employee compensation and benefits on the Consolidated Statements of Operations.

The following table summarizes stock option activity during the three months ended March 31, 2007 (options in millions):

	Number of Options	Weighed- Average Exercise Price
Outstanding at January 1, 2007	8.8	$ 9.43
Granted at market value	0.5	17.93
Exercised	(1.7)	5.95
Surrendered	(0.1)	20.08
Outstanding at March 31, 2007	7.6	$ 10.64
Vested at March 31, 2007	4.1	$ 9.77
Available for future grants at March 31, 2007*	11.6	

* represents both options and awards available for grant

There is $7.6 million of unrecognized compensation related to unvested stock options outstanding at March 31, 2007. The cost of these unvested awards is expected to be recognized over a weighted average life of 1.4 years.

15. Income Taxes

The Company and its subsidiaries file a consolidated federal income tax return as well as combined state income tax returns in certain jurisdictions. In other jurisdictions, the Company and its subsidiaries file separate company state income tax returns.

The following table reconciles the U.S. federal statutory income tax rate from continuing operations to the Company s actual income tax rate:

	For the three months ended March 31, 2007	2006
Income tax expense at the U.S. federal statutory rate	35.0%	35.0%
U.S. state and local income tax expense, net of U.S. federal income tax effect	3.9%	4.9%
Other, net	0.4%	0.2%
Income tax expense	39.3%	40.1%

Effective January 1, 2007 the Company adopted FIN 48. The Company recognized no material adjustment in the liability for unrecognized income tax benefits as a result of the implementation of FIN 48. At the adoption date of January 1, 2007 and at March 31, 2007, the Company had $0.9 million of unrecognized tax benefits, all of which would affect the Company s effective tax rate if recognized.

As of January 1. 2007, the Company is subject to U.S. Federal income tax examinations for the tax years 2004 through 2005, and to non-U.S. income tax examinations for the tax years of 2002 through 2005. In addition, the Company is subject to state and local income tax examinations in various jurisdictions for the tax years 2000 through 2005.

The Company s policy for recording interest and penalties associated with audits is to record such items as a component of Income from continuing operations before income taxes. Penalties are recorded in Other expenses and interest paid or received is recorded in Interest and dividends, net, in the Consolidated Statements of Operations.

16. Business Segments

The Company currently has two operating business segments, Asset Management and Global Markets as well as a Corporate segment. The Asset Management segment consists of investment management and sponsorship of the Deephaven Funds. The Global Markets segment offers superior execution quality through natural liquidity, capital facilitation and trading technology, with comprehensive products and services that support the capital formation process. The Corporate segment includes all corporate overhead expenses and investment income earned on strategic investments and the Company s corporate investment in the Deephaven Funds. Corporate overhead expenses primarily consist of compensation for certain senior executives and other individuals employed at the corporate holding company, legal and other professional expenses relating to corporate matters, directors fees, investor and public relations expenses and directors and officers insurance.

The Company s revenues, income from continuing operations before income taxes and total assets by segment are summarized below (amounts in millions).

	Asset Management	Global Markets	Corporate	Consolidated Total
For the three months ended March 31, 2007:				
Revenues	$ 61.2	$ 172.6	$ 7.8	$ 241.7
Income from continuing operations before income taxes	18.9	36.1	(0.3)	54.7
Total assets	206.5	1,728.1	28.2	1,962.8
For the three months ended March 31, 2006:				
Revenues	$ 70.8	$ 188.7	$ 17.7	$ 277.2
Income from continuing operations before income taxes[1]	26.8	48.5	6.7	82.0
Total assets	106.8	1,190.6	427.6	1,725.0

1 Global Markets segment includes $8.0 million in Writedown of assets and lease loss accrual for the three months ended March 31, 2006 (described in Footnote 8).

Totals may not add due to rounding

Item 2. Management s Discussion and Analysis of Financial Condition and Results of Operations

The following discussion of our results of operations should be read in conjunction with our consolidated financial statements and notes thereto included in our Annual Report on Form 10-K for the year ended December 31, 2006 as filed with the Securities and Exchange Commission (SEC). This discussion contains forward-looking statements that involve risks and uncertainties, including those discussed in our Form 10-K. Our actual results may differ materially from those anticipated in these forward-looking statements as a result of certain factors, including, but not limited to, those set forth elsewhere in this document and in our Form 10-K.

Certain statements contained in this Quarterly Report on Form 10-Q, including without limitation, those under Management s Discussion and Analysis of Financial Condition and Results of Operations herein (MD&A), Quantitative and Qualitative Disclosures About Market Risk in Part I, Item 3, and Legal Proceedings in Part II, Item 1, and the documents incorporated by reference, may constitute forward-looking statements. These forward-looking statements are not historical facts, and are based on current expectations, estimates and projections about the Company s industry, management s beliefs and certain assumptions made by management, many of which, by their nature, are inherently uncertain and beyond our control. Accordingly, readers are cautioned that any such forward-looking statements are not guarantees of future performance and are subject to certain risks, uncertainties and assumptions that are difficult to predict including, without limitation, risks associated with the costs, integration, performance and operation of the businesses recently acquired, or that may be acquired in the future, by the Company and the risks associated with the recent change in management at Deephaven Capital Management LLC (together with its subsidiaries, Deephaven) and the potential impact on the Deephaven business and assets under management. Since such statements involve risks and uncertainties, the actual results and performance of the Company may turn out to be materially different from the results expressed or implied by such forward-looking statements. Given these uncertainties, readers are cautioned not to place undue reliance on such forward-looking statements. Unless otherwise required by law, the Company also disclaims any obligation to update its view of any such risks or uncertainties or to announce publicly the result of any revisions to the forward looking statements made in this report. Readers should carefully review the risks and uncertainties detailed under Certain Factors Affecting Results of Operations within MD&A herein, in Risk Factors in the Company s Annual Report on Form 10-K, and in other reports or documents the Company files from time to time with the SEC. This discussion should be read in conjunction with the Company s Consolidated Financial Statements and the Notes thereto contained in this report.

Executive Overview

We are a leading financial services firm that provides voice and electronic access to the capital markets across multiple asset classes for buy-side, sell-side and corporate clients, and asset management for institutions and private clients. We continually apply knowledge and innovation to the trading and asset management processes to build lasting client partnerships through consistent performance and superior client service. We have two operating business segments, Asset Management and Global Markets, as well as a Corporate segment.

Asset Management Our Asset Management business, Deephaven Capital Management (Deephaven), is a global, multi-strategy alternative investment manager focused on delivering attractive risk-adjusted returns with low correlation to the broader markets for institutions and private clients. Assets under management were $3.9 billion as of April 1, 2007, up from $3.1 billion as of April 1, 2006.

Global Markets Our Global Markets business offers superior execution quality through natural liquidity, capital facilitation and trading technology, with comprehensive products and services that support the capital formation process. We make a market or trade in nearly every U.S. equity security and provide trade execution services in a large number of international securities, futures, options, foreign currencies and fixed income instruments.

The Company s Corporate segment includes all corporate overhead expenses and investment income earned on strategic investments and our corporate investment in funds managed by the Asset Management segment (the

Deephaven Funds). Corporate overhead expenses primarily consist of compensation for certain senior executives and other individuals employed at the corporate holding company, legal and other professional expenses related to corporate matters, directors fees, investor and public relations expenses and directors and officers insurance.

In December 2004, the Company completed the sale of one of its business segments, Derivative Markets, to Citigroup Financial Products Inc. (Citigroup). In accordance with generally accepted accounting principles (GAAP), the results of this segment have been included within discontinued