KNIGHT TRADING GROUP INC
Form 10-Q
May 10, 2005
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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-Q

QUARTERLY REPORT PURSUANT TO SECTION 13 or 15(d)

OF THE SECURITIES EXCHANGE ACT OF 1934

FOR THE QUARTERLY PERIOD ENDED MARCH 31, 2005

001-14223

Commission File Number

KNIGHT TRADING 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 an accelerated filer (as defined in Exchange Act Rule 12b-2) Yes x No ¨

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, 2005 the number of shares outstanding of the Registrant s Class A Common Stock was 107,394,944 and there were no shares outstanding of the Registrant s Class B Common Stock as of such date.

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KNIGHT TRADING GROUP, INC.

FORM 10-Q QUARTERLY REPORT

For the Quarter Ended March 31, 2005

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PART I. FINANCIAL INFORMATION

Item 1. Financial Statements

KNIGHT TRADING GROUP, INC.

CONSOLIDATED STATEMENTS OF OPERATIONS

(Unaudited)

	For the three months ended March 31,	
	2005	**2004**
REVENUES		
Net trading revenue	$ 37,421,828	$ 100,727,855
Commissions and fees	70,116,011	76,637,524
Asset management fees	17,880,667	13,932,132
Interest and dividends, net	2,339,800	857,962
Investment income and other	9,798,564	6,163,997
Total revenues	137,556,870	198,319,470
EXPENSES		
Employee compensation and benefits	56,857,441	65,103,791
Execution and clearance fees	23,546,783	37,762,298
Soft dollar and commission recapture expense	15,484,575	15,775,915
Payments for order flow	7,404,075	13,018,439
Communications and data processing	7,813,959	6,753,777
Depreciation and amortization	4,250,398	3,870,824
Occupancy and equipment rentals	3,996,041	4,435,070
Professional fees	3,776,416	3,353,024
Business development	1,293,336	2,042,971
Other	2,653,746	2,749,333
Total expenses	127,076,770	154,865,442
Income from continuing operations before income taxes	10,480,100	43,454,028
Income tax expense	4,355,145	17,507,342
Net income from continuing operations	6,124,955	25,946,686
(Loss) income from discontinued operations, net of tax	(265,927)	5,867,771
Net income	$ 5,859,028	$ 31,814,457

Basic earnings per share from continuing operations	$ 0.06	$ 0.23
Diluted earnings per share from continuing operations	$ 0.05	$ 0.21
Basic and diluted earnings per share from discontinued operations	$	$ 0.05
Basic earnings per share	$ 0.05	$ 0.28
Diluted earnings per share	$ 0.05	$ 0.26
Shares used in computation of basic earnings per share	108,858,845	113,473,360
Shares used in computation of diluted earnings per share	112,409,158	121,988,464

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

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KNIGHT TRADING GROUP, INC.

CONSOLIDATED STATEMENTS OF FINANCIAL CONDITION

(Unaudited)

	March 31, 2005	December 31, 2004
ASSETS		
Cash and cash equivalents	$ 232,633,119	$ 445,539,282
Securities owned, held at clearing brokers, at market value	279,860,044	254,473,209
Receivable from brokers and dealers	443,635,264	244,881,065
Investment in Deephaven sponsored funds	315,157,464	215,329,959
Fixed assets and leasehold improvements at cost, less accumulated depreciation and amortization	62,953,966	54,024,186
Strategic investments	67,996,445	29,266,796
Goodwill	19,182,248	19,182,248
Intangible assets, less accumulated amortization	11,391,111	11,546,528
Other assets	67,326,039	117,305,578
Total assets	$ 1,500,135,700	$ 1,391,548,851
LIABILITIES & STOCKHOLDERS EQUITY		
Liabilities		
Securities sold, not yet purchased, at market value	$ 226,027,863	$ 221,420,569
Payable to brokers and dealers	330,744,844	88,480,788
Accrued compensation expense	49,226,779	123,664,383
Accrued expenses and other liabilities	60,321,008	103,485,220
Total liabilities	666,320,494	537,050,960
Stockholders equity		
Class A Common Stock, $0.01 par value, 500,000,000 shares authorized; 138,119,863 shares issued and 110,741,677 shares outstanding at March 31, 2005 and 133,965,513 shares issued and 113,295,191 shares outstanding at December 31, 2004	1,381,199	1,339,655
Additional paid-in-capital	463,946,314	427,451,712
Retained earnings	596,307,811	590,448,783
Treasury stock, at cost; 27,378,186 shares at March 31, 2005 and 20,670,322 shares at December 31, 2004	(216,604,389)	(147,636,413)
Accumulated other comprehensive income, net of tax	23,886,641	
Unamortized stock-based compensation	(35,102,370)	(17,105,846)
Total stockholders equity	833,815,206	854,497,891
Total liabilities and stockholders equity	$ 1,500,135,700	$ 1,391,548,851

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

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KNIGHT TRADING GROUP, INC.

CONSOLIDATED STATEMENTS OF CASH FLOWS

(Unaudited)

	For the three months ended March 31,	
	2005	**2004**
Cash flows from operating activities		
Net income	$ 5,859,028	$ 31,814,457
(Loss) income from discontinued operations, net of tax	(265,927)	5,867,771
Income from continuing operations, net of tax	6,124,955	25,946,686
Adjustments to reconcile income from continuing operations, net of tax to net cash used in operating activities		
Depreciation and amortization	4,250,398	3,870,824
Income tax benefit on stock awards exercised	3,822,249	2,153,142
Stock based compensation	2,946,743	1,902,778
Unrealized gain on strategic investments	(280,432)	(100,249)
(Increase) decrease in operating assets		
Securities owned	(25,386,835)	(124,684,970)
Receivable from brokers and dealers	(198,754,199)	(32,180,201)
Receivable from discontinued operations		(88,124,976)
Other assets	33,519,266	747,165
Increase (decrease) in operating liabilities		
Securities sold, not yet purchased	4,607,294	97,381,978
Payable to brokers and dealers	242,264,056	72,573,444
Accrued compensation expense	(74,437,605)	(33,821,578)
Accrued expenses and other liabilities	(43,152,175)	8,699,148
Net cash used in operating activities	(44,476,285)	(65,636,809)
Cash flows from investing activities		
Purchases of fixed assets and leasehold improvements	(13,036,788)	(2,841,758)
Investment in Deephaven sponsored funds	(99,827,505)	(29,830,576)
Net proceeds from (purchases of) strategic investments	1,939,166	(4,481,860)
Net cash used in investing activities	(110,925,127)	(37,154,194)
Cash flows from financing activities		
Stock options exercised	11,729,152	4,837,123
Cost of common stock repurchased	(68,967,976)	(6,209,088)
Purchase of shares from minority investors in Knight Roundtable Europe Limited		(2,328,632)
Net cash used in financing activities	(57,238,824)	(3,700,597)

Decrease in cash and cash equivalents	(212,640,236)	(106,491,600)
Net cash (used in) provided by discontinued operations	(265,927)	1,831,072
Cash and cash equivalents at beginning of the year	445,539,282	249,997,693
Cash and cash equivalents at end of the period	$ 232,633,119	$ 145,337,165
Supplemental disclosure of cash flow information:		
Cash paid for interest	$ 37,126	$ 67,800
Cash paid for income taxes	$ 45,295,349	$ 12,023,081

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

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KNIGHT TRADING GROUP, INC.

NOTES TO CONSOLIDATED FINANCIAL STATEMENTS

MARCH 31, 2005

(Unaudited)

1. Organization and Description of the Business

Knight Trading Group, Inc. and its subsidiaries (the Company) have two operating business segments, Asset Management and Equity Markets, and a Corporate segment. The Company s operating business segments from continuing operations comprise the following operating subsidiaries:

Asset Management

Deephaven Capital Management LLC (Deephaven) is the investment manager and sponsor of the Deephaven investment funds (the Deephaven Funds). Deephaven also has a U.K. registered investment advisor subsidiary, which is regulated by the Financial Services Authority (FSA) in the U.K.

Equity 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 (OTCBB). Additionally, in December 2003, KEM acquired the business of Donaldson & Co., Incorporated (Donaldson), a firm that offers soft dollar and commission recapture services. KEM is a broker-dealer registered with the Securities and Exchange Commission (SEC) and is a member of the National Association of Securities Dealers (NASD), the National Stock Exchange and the Pacific Stock Exchange.

Knight Capital Markets LLC (KCM) 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 the NASD.

Knight Equity Markets International Limited (KEMIL) is a U.K. registered broker-dealer that provides execution services for European institutional and broker-dealer clients in U.S. and European equities. KEMIL is regulated by the FSA and is a member of the London Stock Exchange.

The Corporate segment includes all corporate overhead expenses and investment income earned on strategic investments and our 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, 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 cash as of the close of business on December 9, 2004. In accordance with generally accepted accounting principles (GAAP), the results of the Derivative Markets segment, as well as the gain on the sale of this business, have been included within discontinued operations for all periods presented. The final purchase price was subject to adjustment based on the final determination of the book value of the Derivative Markets business at the time the deal closed. The final determination of the book value was completed during the first quarter of 2005. For a further discussion of the sale of the Company s Derivative Markets business and its associated accounting treatment, see Footnote 8 Discontinued Operations.

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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 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, 2004 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, or short-term investments with an original maturity of less than 30 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. As disclosed in the Company s Annual Report on Form 10-K, in 2004, the Company changed its classification of certain transaction-related regulatory fees. These fees are now included within Execution and clearance fees. In prior periods, these fees were netted within Net trading revenue. The transaction-related regulatory fees were $4.7 million and $8.4 million for the three months ended March 31, 2005 and 2004, respectively. As a result of this change, prior period amounts have been reclassified to conform to current period presentation.

Payments for order flow represent payments to broker-dealer clients for directing their order executions to the Company. 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

The Company earns asset management fees for sponsoring and managing the Deephaven Funds. Such fees are recorded monthly as earned and are calculated as a percentage of the Deephaven Funds monthly net assets, plus a percentage of a new high net asset value (the Incentive Allocation Fee), as defined, for any six month period ended June 30th or December 31st. A new high net asset value is generally defined as the amount by which the net asset value of the Deephaven Funds exceeds the greater of either the highest previous net asset value in the Deephaven Funds, 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. If Deephaven s Market Neutral Fund, which contains the majority of assets under management, recognizes a loss in the second half of a calendar year, the Incentive Allocation Fee is recalculated on an annual rather than a semi-annual basis. As such, the Incentive Allocation Fee may be negative for certain periods, but not lower than zero on a year-to-date basis.

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Estimated fair value of financial instruments

The Company s securities owned and securities sold, not yet purchased are carried at market value, which 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.

Accounting for derivatives

The Company s derivative financial instruments, primarily comprised of listed futures, are all held for trading purposes and are carried at market value.

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 over their useful lives.

Strategic investments

Strategic investments include equity ownership interests of less than 20% in financial services-related businesses and are accounted for under the equity method or at fair value. The equity method of accounting is used for investments in limited partnerships and limited liability corporations. Investments that are classified as available-for-sale, which include the Company s investments in Nasdaq and the International Securities Exchange (ISE), are reported at fair value with unrealized gains and losses excluded from earnings and reported, net of applicable taxes, in Accumulated other comprehensive income, net of tax within Stockholders Equity on the Consolidated Statements of Financial Condition. The fair value of investments for which a quoted market or dealer price is not available for the size of our investment, is based on management s estimate. Among the factors considered by management in determining the fair value of 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. The valuations of strategic investments are reviewed by management on an ongoing basis.

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 consolidated 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.

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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 no longer actively used and are determined to be impaired. The amount of the impairment writedown is determined by the difference between the carrying amount and the 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 quarterly 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* (which requires the accrual of future costs to be made using a discounted cash flow analysis for lease losses initiated after such date), and costs related to the excess capacity are accrued.

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 are measured using the enacted tax rates and laws that will be in effect when such differences are expected to reverse. 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.

Discontinued Operations

In accordance with SFAS No. 144, *Accounting for the Disposal of Long-Lived Assets*, the revenues and expenses associated with a separate business segment or reporting unit that has been disposed of through closure or sale are included within (Loss) income from discontinued operations, net of tax, on the Consolidated Statements of Operations for all periods presented.

Stock-based compensation

The Company applies Accounting Principles Board Opinion No. 25, *Accounting for Stock Issued to Employees* (APB 25) and related interpretations in accounting for its stock options plans. As options are granted at the then market value, no compensation expense has been recognized for the fair values of the options granted to employees.

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Had compensation expense for the Company s options been determined based on the fair value at the grant dates in accordance with SFAS No. 123, *Accounting for Stock-Based Compensation*, the Company s net income and earnings per share amounts for the three months ended March 31, 2005 and 2004, respectively would have been as follows (in millions, except per share data):

	Three months ended March 31,	
	2005	**2004**
Net income, as reported	$ 5.9	$ 31.8
Pro forma compensation expense determined under fair value based method, net of tax	(1.4)	(2.1)
Pro forma net income	4.5	29.8
Basic earnings per share, as reported	0.05	0.28
Diluted earnings per share, as reported	0.05	0.26
Pro forma basic earnings per share	0.04	0.26
Pro forma diluted earnings per share	0.04	0.24

The Company records the fair market value of restricted stock awards on the date of grant as unamortized stock-based compensation in Stockholders equity and amortizes the balance to compensation expense ratably over the vesting period.

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, 2005	**December 31, 2004**
Securities owned:		
Equities	$ 270.9	$ 245.5
U.S. government obligations	9.0	9.0
	$ 279.9	$ 254.5

Securities sold, not yet purchased:		
Equities	$ 226.0	$ 221.4
	$ 226.0	$ 221.4

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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, 2005	December 31, 2004
Receivable:		
Clearing brokers	$ 375.4	$ 141.0
Securities failed to deliver	45.2	64.5
Securities borrowed	20.8	35.0
Other	2.2	4.4
	$ 443.6	$ 244.9
Payable:		
Clearing brokers	$ 310.5	$ 47.7
Securities failed to receive	20.2	40.7
Other	0.0	0.1
	$ 330.7	$ 88.5

5. Goodwill and Intangible Assets

In June 2004, the Company tested for the impairment of goodwill and intangible assets and concluded that there was no impairment. The Company plans on performing its annual test for impairment during the second quarter of 2005. The goodwill balance of $19.2 million at March 31, 2005 related to the Equity Markets 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. In the first half of 2004, the Company acquired all of the ownership interests of the minority owners of Knight Roundtable Europe Limited (KREL) (which is the Company s subsidiary that owns KEMIL) for $2.5 million, which was recorded as goodwill and is attributable to the Equity Markets business segment.

At March 31, 2005, the Company had intangible assets, net of accumulated amortization, of $11.4 million, all included within the Equity Markets business segment. Substantially all of the intangible assets, net of accumulated amortization, of $11.4 million, resulted from the purchase of the business of Donaldson and primarily represent customer relationships. The carrying value of these intangible assets is being amortized over the remaining useful lives, which have been determined to range from five to thirty years.

In the first quarter of 2005, the Company recorded amortization expense related to its intangible assets within its Equity Markets business segment of $155,000. The estimated amortization expense relating to the intangible assets for each of the next five years approximates $466,000 for the remainder of 2005, $620,000 per year from 2006 through 2008, and $560,000 in 2009.

The chart below summarizes the activity of the Company s Goodwill and Intangible assets, net of accumulated amortization, for the three months ended March 31, 2004 and 2005, respectively (in millions).

	Equity Markets	
	Goodwill	Intangible Assets
Balance at January 1, 2004	$ 16.7	$ 12.0
Purchase of shares from minority investors in KREL	2.3	
Amortization expense		(0.1)
Balance at March 31, 2004	$ 19.0	$ 11.9
Balance at January 1, 2005	$ 19.2	$ 11.5
Amortization expense		(0.2)
Balance at March 31, 2005	$ 19.2	$ 11.4

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6. Investment in Deephaven Sponsored Funds and Strategic Investments

The Company s wholly-owned subsidiary, Deephaven, is the investment manager and sponsor of the Deephaven Funds, which engages in various trading strategies involving equities, debt instruments and derivatives. The underlying investments in the Deephaven Funds are carried at market value. Of the $3.5 billion of assets under management in the Deephaven Funds as of March 31, 2005, the Company had a corporate investment of $315.2 million. On January 1, 2005, the Company invested an additional $100.0 million into the Deephaven Funds, which was redeemed on April 1, 2005. Additionally, Other assets on the Consolidated Statements of Financial Condition at March 31, 2005 and December 31, 2004 included $22.5 million and $19.9 million, respectively, of investments in the Deephaven Funds related to employee deferred compensation plans. In addition, certain officers, directors and employees of the Company had direct investments of approximately $4.4 million in the Deephaven Funds, in the aggregate, as of March 31, 2005.

Strategic investments, which primarily include the Company s investments in the ISE and Nasdaq, are reviewed on an ongoing basis to ensure that the fair values of the investment have not been impaired. The Company s investments in the ISE and Nasdaq are classified as available-for-sale securities, and have an aggregate fair value of $54.7 million as of March 31, 2005. On March 9, 2005, in conjunction with the ISE s initial public offering, the Company sold approximately 30% of its original equity ownership of the ISE. As a result of the transaction, the Company recognized a pre-tax gain of $9.6 million. As of March 31, 2005, the Company owned 1.7 million shares of common stock of the ISE.

7. Significant Clients

The Company considers significant clients to be clients who account for 10% or more of the total U.S. equity dollar value traded by the Company during the period. One customer accounted for approximately 11.5% of the Company s U.S. equity dollar value traded during the three months ended March 31, 2005. Payments for order flow to this firm for U.S. equity order flow for the three months ended March 31, 2005 amounted to $4.1 million.

The Company s corporate investment in the Deephaven Funds of $315.2 million accounted for 9.1% of total assets under management as of March 31, 2005. On April 1, 2005, the Company redeemed $100.0 million of its corporate investment. One institutional investor accounted for more than 10% of the Deephaven Funds assets under management, with 10.9% as of March 31, 2005.

8. Discontinued Operations

Derivative Markets

The Company completed the sale of its Derivative Markets business to Citigroup for $237 million in cash as of the close of business on December 9, 2004. The final purchase price was subject to adjustment based on the final determination of the book value of the Derivative Markets business at the time the deal closed. The final determination of book value occurred in the first quarter of 2005, at which time the adjustment was recognized. The result of this adjustment and other expenses related to the sale resulted in a loss from discontinued operations, net of tax, of $266,000 in the first quarter 2005.

The decision to sell the Derivative Markets business was based on a review of the overall options industry, the capital and risk required to maintain this business successfully and the business role in the Company s long-term strategy. In accordance with SFAS No. 144, *Accounting for the Disposal of Long-Lived Assets*, the results of the Derivative Markets segment, the revenues and expenses associated with these businesses as well as all costs associated with the sale transaction have been included in (Loss) income from discontinued operations, net of tax on the Consolidated Statements of Operations for all periods presented.

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The revenues and results of operations of the discontinued operations for the three months ended March 31, 2005 and 2004 are summarized as follows (in millions):

	For the three months ended	
	March 31, 2005	March 31, 2004
Revenues	$	$ 49.9
Pre-tax (loss) income from discontinued operations	(0.4)	9.9
Income tax (benefit) expense	(0.2)	4.0
(Loss) income from discontinued operations, net of tax	$ (0.3)	$ 5.9

9. 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. 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. The office leases contain certain escalation clauses whereby the rental commitments may be increased if certain conditions are satisfied and specify yearly adjustments to the lease amounts based on annual adjustments to the Consumer Price Index. Rental expense, from continuing operations, under the office leases was $2.6 million and $2.7 million for the three months ended March 31, 2005 and 2004, respectively.

The Company leases certain computer and other equipment under noncancelable operating leases. In addition, the Company has entered into guaranteed employment contracts with certain of its employees. As of March 31, 2005, future minimum rental commitments under all noncancelable office, computer and equipment leases (Operating Leases), and obligations on clearing contracts and guaranteed employment contracts longer than one year (Other Obligations) were as follows:

	Operating Leases	Other Obligations	Total
Nine months ending December 31, 2005	$ 10.2	$	$ 10.2
Year ending December 31, 2006	9.9	16.0	25.9
Year ending December 31, 2007	9.4		9.4
Year ending December 31, 2008	9.2		9.2

Year ending December 31, 2009	8.9		8.9
Thereafter through September 30, 2021	109.0		109.0
	$ 156.6	$ 16.0	$ 172.6

During the normal course of business, the Company collateralizes certain leases, employment agreements or other contractual obligations through letters of credit or segregated funds held in escrow accounts. As of March 31, 2005, the Company has provided a $9.0 million letter of credit, collateralized by U.S. Treasury Bills, as a guarantee for one of the Company s lease obligations.

The Company entered into long-term employment contracts with the senior management team of Deephaven (the Deephaven managers). These employment agreements, which became effective on January 1,

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2004, are for three-year terms and include an option for renewal by the Deephaven managers through 2009 under certain circumstances. Pursuant to the terms of a simultaneously executed option agreement between the Company and the Deephaven managers, in the event of a change of control of the Company during the initial three-year employment term, the Deephaven managers would have the option (the Option) to obtain a 51% interest in Deephaven in exchange for the termination of their employment contracts and associated profit-sharing bonuses and other employee profit-sharing plans, which in the aggregate range from 42% to 50% of the pre-tax, pre-profit sharing profits of Deephaven during the term of the agreements, subject to meeting certain annual guaranteed amounts. If a change of control of the Company were to occur, and if the Deephaven managers exercised the Option, the Company would retain a 49% interest in Deephaven. In addition, during the life of the Option, the agreements provide that the Company may not sell Deephaven without the approval of the Deephaven managers.

10. Comprehensive Income

Comprehensive income includes net income and changes in equity except those resulting from investments by, or distributions to, stockholders. Comprehensive income is as follows:

	Three months ended March 31,	
	2005	**2004**
Net income	$ 5.9	$ 31.8
Other comprehensive income, net of tax:		
Net unrealized gain on investment securities available-for-sale	23.9	
Total comprehensive income, net of tax	$ 29.8	$ 31.8

Other comprehensive income, net of tax represents net unrealized gains on the Company s strategic investments in the ISE and Nasdaq.

11. 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 Class A Common Stock.

The following is a reconciliation of the numerators and denominators of the basic and diluted earnings per share computations for the three months ended March 31, 2005 and 2004 (in millions, except for share and per share data):

	For the three months ended March 31,

	2005		2004	
	Numerator / net income	Denominator / shares	Numerator / net income	Denominator / shares
Net income and shares used in basic calculations	$ 5.9	108,858,845	$ 31.8	113,473,360
Effect of dilutive stock based awards		3,550,313		8,515,104
Net income and shares used in diluted calculations	$ 5.9	112,409,158	$ 31.8	121,988,464
Basic earnings per share		$ 0.05		$ 0.28
Diluted earnings per share		$ 0.05		$ 0.26

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12. Stock-Based Compensation

The Company has established the Knight Trading Group, Inc. 1998 Long Term Incentive Plan, the Knight Trading Group, Inc. 1998 Nonemployee Director Stock Option Plan and the Knight Trading Group, Inc. 2003 Equity Incentive Plan (collectively, the Plans). The purpose of the Plans is to provide long-term incentive compensation to employees and directors of the Company. The Plans are administered by the Compensation Committee of the Company s Board of Directors, and allow for the grant of options, restricted stock and restricted stock units (collectively, the awards), as defined by the Plans. In addition, the Plans limit the number of options or shares that may be granted to a single individual and the Plans also limit the number of shares of restricted stock that may be awarded.

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 Plans define as the average of the high and low sales prices on the date prior to the grant date. Options generally vest 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 agreements. Restricted stock awards generally vest over three years. The Company has the right to fully vest employees in their awards upon retirement and in certain other circumstances.

The Company granted 2,162,044 restricted shares under the Plans during the first quarter of 2005 as stock-based compensation. At March 31, 2005, the Company had 3,977,274 restricted shares outstanding, in aggregate, both under and outside of the Plans. The Company recognizes compensation expense for the fair values of the restricted shares of Class A Common Stock granted to employees over the vesting period. For the three months ended March 31, 2005 and 2004, the Company recorded compensation expense related to its continuing operations for the fair values of the restricted shares of Class A Common Stock granted to employees of $2.9 million and $1.9 million, respectively, all of which has been included in Employee compensation and benefits in the Consolidated Statements of Operations.

13. 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 provision to the U.S. federal statutory income tax rate:

	For the three months ended March 31,	
	2005	**2004**
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	5.5%	4.8%
Other, net	1.1%	0.5%
Income tax expense	41.6%	40.3%

14. Business Segments

The Company currently has two operating business segments in continuing operations, Equity Markets and Asset Management, and a Corporate segment. The Equity Markets segment primarily represents market-making in U.S. equities. The Asset Management segment consists of investment management and sponsorship of the Deephaven Funds. 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

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overhead expenses, which 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, investor and public relations expenses and directors and officers insurance.

In 2004, the Company sold one of its business segments, Derivative Markets. The revenues and expenses associated with Derivative Markets have been included within (Loss) income from discontinued operations, net of tax on the Consolidated Statements of Operations for all periods presented. For a discussion of discontinued operations, see Footnote 8, Discontinued Operations.

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

	Equity Markets	Asset Management	Corporate	Consolidated Total
For the three months ended March 31, 2005:				
Revenues	$ 108.0	$ 18.1	$ 11.5	$ 137.6
(Loss) income from continuing operations before income taxes	(0.5)	5.1	5.9	10.5
Total assets	1,009.4	45.2	445.5	1,500.1
For the three months ended March 31, 2004:				
Revenues	$ 177.9	$ 14.0	$ 6.4	$ 198.3
Income (loss) from continuing operations before income taxes	40.3	5.8	(2.6)	43.5
Total assets[1]	869.4	24.0	344.8	1,238.2

[1] - Total assets at March 31, 2004 do not include Assets within discontinued operations of $3.3 billion.

15. Subsequent Events

In April 2005, the Company announced that it had reached an agreement to acquire, for cash, the business of Direct Trading Institutional, Inc., a privately held firm specializing in providing institutions with direct market access trading through an advanced electronic platform. Additionally, in May 2005, the Company announced that it had reached an agreement to acquire, for cash, the business of the ATTAIN ECN, an alternative trading system that operates an electronic communications network (ECN) for the trading of Nasdaq securities. The consummation of each of these transactions is subject to regulatory approval and the satisfaction of certain other customary conditions.

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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, 2004 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 and integration, performance and operation of the businesses being acquired by the Company. 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 under Certain Factors Affecting Results of Operations within MD&A herein, Risks Affecting our Business in the Company s Annual Report on Form 10-K, and those described 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

The Company currently has two operating business segments, Asset Management and Equity Markets, and a Corporate segment.

> **Asset Management** We operate an asset management business for institutions and high-net-worth individuals. Assets under management were $3.5 billion as of March 31, 2005, up $1.3 billion from the $2.2 billion of assets under management as of March 31, 2004.
>
> **Equity Markets** We are a leading execution specialist providing comprehensive trade execution services to institutional and broker-dealer clients, offering capital commitment and access to a deep pool of liquidity across the depth and breadth of the U.S. equity markets. As announced in April 2005, the Company reorganized its Equity Markets business segment into three different business groups: Broker-Dealer, Electronic Services and Institutional. The reorganization will allow the Company to better focus on and improve the service to the different client groups of the Equity Markets segment.

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, investor and public relations expenses and directors and officers insurance.

In the fourth quarter of 2004, the Company completed the sale of one of its business segments, Derivative Markets,