KNIGHT CAPITAL GROUP, INC.
Form 10-K
March 14, 2006
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SECURITIES AND EXCHANGE COMMISSION

Washington, D.C. 20549

FORM 10-K

x **ANNUAL REPORT PURSUANT TO SECTION 13 OR 15(d) OF THE SECURITIES EXCHANGE ACT OF 1934 FOR THE FISCAL YEAR ENDED DECEMBER 31, 2005**

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

Securities registered pursuant to Section 12(b) of the Act:

None.

Securities registered pursuant to Section 12(g) of the Act:

Class A Common Stock, $0.01 par value

Indicate by check mark if the registrant is a well-known seasoned issuer, as defined in Rule 405 of the Securities Act. Yes x No ¨

Indicate by check mark if the registrant is not required to file reports pursuant to Section 13 or Section 15(d) of the Act. Yes ¨ No x

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 if disclosure of delinquent filers pursuant to Item 405 of Regulation S-K is not contained herein and will not be contained, to the best of Registrant s knowledge, in definitive proxy or information statements incorporated by reference in Part III of this Form 10-K or any amendment to this Form 10-K. Yes x No ¨

Indicate by check mark whether the registrant is a large accelerated filer, an accelerated filer, or a non-accelerated filer (as defined in Exchange Act Rule 12b-2) 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

The aggregate market value of the Class A Common Stock held by nonaffiliates of the Registrant was approximately $755.7 million at June 30, 2005 (the last business day of the Registrant s most recently completed second fiscal quarter) based upon the closing price for shares of the Registrant s Class A Common Stock as reported by the National Market System of the Nasdaq Stock Market on that date. For purposes of this calculation, affiliates are considered to be officers, directors and holders of 10% or more of the outstanding common stock of the Registrant.

At March 13, 2006 the number of shares outstanding of the Registrant s Class A Common Stock was 103,814,628 and there were no shares outstanding of the Registrant s Class B Common Stock as of such date.

DOCUMENTS INCORPORATED BY REFERENCE

Definitive Proxy Statement relating to the Company s 2006 Annual Meeting of Stockholders to be filed hereafter (incorporated, in part, into Part III hereof).

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KNIGHT CAPITAL GROUP, INC.

FORM 10-K ANNUAL REPORT

For the Year Ended December 31, 2005

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FORWARD LOOKING STATEMENTS

Certain statements contained in this Annual Report on Form 10-K, including without limitation, those under Legal Proceedings in Part I, Item 3, Management s Discussion and Analysis of Financial Condition and Results of Operations in Part II, Item 7 (MD&A), and Quantitative and Qualitative Disclosures about Market Risk in Part II, Item 7A, and the documents incorporated by reference may constitute forward-looking statements as defined in the Private Securities Litigation Reform Act of 1995. 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 businesses recently acquired, or 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 detailed under Certain Factors Affecting Results of Operations in MD&A and in Risk Factors in Part I, Item 1A herein, and in other reports or documents the Company files from time to time with the Securities and Exchange Commission. This discussion should be read in conjunction with the Company s Consolidated Financial Statements and the Notes thereto contained in this report.

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PART I

Item 1. *Business*

Overview

Knight Capital Group, Inc., a Delaware corporation, and its subsidiaries (collectively Knight or the Company) is a leading financial services firm that provides comprehensive trade execution solutions and asset management services. Our Global Markets business provides a broad range of customized trade execution products and services across multiple asset classes for broker-dealers, institutions and issuer companies. Our Asset Management business, Deephaven Capital Management, 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. 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.

Knight Capital Group, Inc. was organized in January 2000 as the successor to the business of Knight/Trimark Group, Inc. (the Predecessor). The Predecessor was organized in April 1998 as the successor to the business of Roundtable Partners, LLC, which was formed in March 1995. In May 2000, the Company changed its name from Knight/Trimark Group, Inc. to Knight Trading Group, Inc., and in May 2005 the Company changed its name to Knight Capital Group, Inc. Our corporate headquarters are located at 545 Washington Boulevard, Jersey City, New Jersey 07310. Our telephone number is (201) 222-9400.

Financial information concerning our business segments for each of 2005, 2004 and 2003, respectively, is set forth in Management s Discussion and Analysis of Financial Condition and Results of Operations in Part II, Item 7 and the Consolidated Financial Statements and Notes thereto located in Part II, Item 8 entitled Financial Statements and Supplementary Data.

Available Information

Our Internet address is www.knight.com. We make available free of charge, on or through the Investor Center section of our corporate web site under SEC Filings , annual reports on Form 10-K, quarterly reports on Form 10-Q, current reports on Form 8-K, Forms 3, 4 and 5 filed on behalf of directors and executive officers, and any amendments to those reports filed or furnished pursuant to the Securities Exchange Act of 1934, and our proxy statements as soon as reasonably practicable after such material is electronically filed with, or furnished to, the United States Securities and Exchange Commission (SEC). Also posted on our corporate web site is our Code of Business Conduct and Ethics (the Code) governing our directors, officers and employees. Within the time period required by the SEC, we will post on our corporate web site any amendments and waivers to such Code applicable to our executive officers and directors, as defined in the Code.

In addition, our Board of Directors (the Board) has standing Finance and Audit, Compensation and Nominating and Corporate Governance Committees. Each of these Board committees has a written charter approved by the Board. Our Board has also adopted a set of Corporate Governance Guidelines. Copies of each committee charter, along with the Corporate Governance Guidelines, are also posted on the Company s web site. None of the information on our corporate web site is incorporated by reference into this report.

All of the above materials are also available in print, without charge, to any person who requests them by writing or telephoning:

Knight Capital Group, Inc.

Corporate Communications and Investor Relations

545 Washington Boulevard

Jersey City, NJ 07310

(201) 222-9400

Unless otherwise indicated, references to the Company, Knight, We, or Our shall mean Knight Capital Group, Inc. and its subsidiaries.

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Business Segments

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

Asset Management Our Asset Management business, Deephaven Capital Management, 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 $2.9 billion as of December 31, 2005, down from $3.6 billion as of December 31, 2004.

Global Markets Our Global Markets business provides a broad range of customized trade execution products and services across multiple asset classes for broker-dealers, institutions and issuer companies. We make a market or trade in nearly every U.S. equity security and provide trade executions in a large number of international securities.

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. 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, to Citigroup Financial Products Inc. (Citigroup). In accordance with generally accepted accounting principles (GAAP), the results of this segment have been included within discontinued operations for all periods presented. For a further discussion of the sale of the Company s Derivative Markets business, see Footnote 9 Discontinued Operations included in Part II, Item 8 Financial Statements and Supplementary Data of this document.

The following table sets forth: (i) revenues, (ii) expenses, excluding Regulatory charges and related matters and Writedown of assets and lease loss accrual (Operating Expenses) and (iii) income (loss) from continuing operations before Regulatory charges and related matters and Writedown of assets and lease loss accrual and income taxes (Pre-Tax Operating Earnings) of our segments and on a consolidated basis (in millions):

	2005	2004	2003
Asset Management			
Revenues	$ 89.8	$ 78.2	$ 58.4
Operating Expenses	63.2	48.6	28.9
Pre-Tax Operating Earnings	26.5	29.6	29.5
Global Markets			
Revenues	470.7	531.0	459.0
Operating Expenses	425.6	461.1	387.2
Pre-Tax Operating Earnings	45.1	69.9	71.8
Corporate			

Revenues	74.2	16.6	28.5
Operating Expenses	24.9	33.5	29.7
Pre-Tax Operating Earnings	49.3	(16.9)	(1.2)
Consolidated			
Revenues	634.6	625.8	545.9
Operating Expenses	513.7	543.2	445.8
Pre-Tax Operating Earnings	$ 120.9	$ 82.6	$ 100.1

Totals may not add due to rounding

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A reconciliation of the income (loss) from continuing operations before income taxes, in accordance with GAAP, (Pre-Tax GAAP Income) to Pre-Tax Operating Earnings and of total GAAP expenses to Operating Expenses is included in Part II, Item 7 Management s Discussion and Analysis of Financial Condition and Results of Operations.

Asset Management Segment

Business Segment Overview

We operate an Asset Management business through our subsidiary Deephaven Capital Management LLC (Deephaven). Deephaven is the investment manager and sponsor of certain private, unregistered funds commonly referred to as hedge funds (the Deephaven Funds). Generally, hedge funds are defined as pools of capital that may invest in any asset class, including derivatives, and may use long and short positions, derivative instruments, and leverage in order to generate returns for investors. A distinguishing feature of hedge funds is their use of long or short positions to seek to offset market risks and isolate arbitrage opportunities. Deephaven also has businesses in London and Hong Kong, through its subsidiaries, Deephaven Capital Management International Ltd. and Deephaven Asia Limited.

Below is a summary of our assets under management at December 31, 2005, 2004 and 2003, and the blended fund returns for the years then ended:

	2005	2004	2003
Year-end assets under management (billions)	$ 2.9	$ 3.6	$ 1.6
Annual fund return to investors*	7.2%	6.5%	13.9%

* Annual fund return represents the blended annual return across all assets under management in the Deephaven Funds.

We earn fees from managing the Deephaven Funds, which consist of annual management fees, calculated as fixed percentages of assets under management, and incentive fees, which, in general, are calculated as a percentage of the funds annual profits, if any. The Deephaven Funds bear the majority of operating expenses associated with the Funds.

We entered into long-term employment contracts with the members of the senior management team of Deephaven (the Deephaven managers) in 2003. These employment agreements, which became effective on January 1, 2004, are for three-year terms, the first of which ends on December 31, 2006. The agreements 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, 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 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.

Clients and Products

In Asset Management, our clients include the Deephaven Funds and institutional investors. Investors in the Deephaven Funds include institutions, funds-of-funds, pension plan sponsors, trusts, endowments and private clients. We differentiate ourselves based on our reputation, client relationships, experience and stability of the management team, investment strategies, leverage, risk profile and historical fund returns. Included within Deephaven s $2.9 billion of assets under management as of December 31, 2005 is a corporate investment of approximately $282 million held by the Company and approximately $21 million of investments held by employee deferred compensation plans and certain officers, directors and employees of the Company. As of December 31, 2005, one institutional investor accounted for 10.1% of Deephaven Funds assets under management.

Currently, approximately 50% of the Deephaven Funds assets under management are in the Deephaven Market Neutral Master Fund (Market Neutral Fund). The investment philosophy for the Market Neutral Fund is to seek to produce returns for its investors using market-neutral investment strategies focusing on the preservation of capital. The general objective of market neutral strategies is to endeavor to capture mispricings or spreads between related capital instruments. Because the primary basis of the Market Neutral Fund s strategy is endeavoring to capture mispricings or spreads between related instruments, rather than attempting to predict or follow absolute price movements, the performance of the Market Neutral Fund is intended to be substantially non-correlated with the general debt and equity markets, as well as with a number of other non-traditional investment strategies. Its returns are primarily dependent upon equity trading volumes, equity volatility, mergers and acquisitions and secondary offering activity in the capital markets, and credit spread relationships, among other factors. Within the Market Neutral Fund, Deephaven generally employs a variety of market neutral investment strategies, including convertible arbitrage, event arbitrage, relative value equity and distressed debt and credit arbitrage, although the fund, and other funds managed by Deephaven, may also pursue investments in special situations, which include, for example, investments in real estate, oil and gas projects, and private equity or debt holdings. As of the end of 2005, the majority of the assets within the Market Neutral Fund were invested within global convertible arbitrage (approximately 37%), relative value equity (approximately 23%), global event arbitrage (approximately 22%) and distressed debt and credit arbitrage (approximately 18%) strategies. As of December 31, 2005, the Market Neutral Fund had approximately $1.5 billion in assets under management.

In the second quarter of 2004, Deephaven launched a new single-strategy fund, the Deephaven Event Fund (Event Fund). The investment strategy of the Event Fund is event arbitrage, which involves investing in securities of issuers subject to event driven situations, such as, mergers, acquisitions, corporate restructurings, spin-offs, or trade opportunities from market imbalances created by these types of transactions. The arbitrage aspects of the Event Fund s strategy involve an assessment of the likelihood that the transaction will be consummated and the resulting determination of how large an exposure to acquire, as well as how and when to hedge such exposure. As of December 31, 2005, the Event Fund held approximately $1.0 billion in assets under management.

In 2005, Deephaven also managed the following single-strategy funds: the Deephaven Global Convertibles Select Opportunities Fund, the Deephaven Credit Opportunities Fund and the Deephaven Long Short Equity Fund (Long Short Fund). Deephaven also manages several separately managed accounts for institutional investors. As of December 31, 2005, these three single-strategy funds and all separately managed accounts had, in aggregate, approximately $367 million of assets under management. In the first quarter of 2006, Deephaven began the process of closing the Long Short Fund.

In order to offer additional product choices for its client base, Deephaven may, in the future, look to increase the number of single-strategy funds it manages. Deephaven is also increasing the allocation of its assets under management invested in Europe and Asia.

Asset Management Competition

Deephaven competes primarily with other asset management companies that manage and sponsor market neutral, event arbitrage, credit arbitrage, long short equity and convertible portfolios. As Deephaven launches new single strategy funds, it will compete with other asset management companies with similar investment strategies. Competition is primarily based on reputation, client relationships, the experience and stability of the management team, investment strategies, leverage, risk profile, fee structures and historical fund returns.

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There has been an on-going trend among fund management companies and institutions to allocate more of their assets to hedge fund investments. This has influenced the growth of the hedge fund industry, as shown in the table below. The continued growth of the hedge fund industry may provide for greater competition in the future.

	Estimated number of hedge funds	Estimated total assets under management (millions)
1990	610	$ 38,910
1995	2,383	185,750
2000	3,873	490,580
2004	7,436	972,608
2005	8,661	1,105,385

Source: Hedge Fund Research, Inc. 2005 Industry Report

Asset Management Infrastructure

In the management of the Deephaven Funds, Asset Management uses both an in-house developed proprietary order management system and a third-party portfolio management system. Deephaven also has a business continuity operation in place in the event it is unable to access or operate in its current location.

Global Markets Segment

Business Segment Overview

We are a leading execution specialist providing a broad range of customizable trade execution products and services across multiple asset classes for broker-dealers, institutions and issuer companies. We offer capital facilitation and access to a natural pool of liquidity across the depth and breadth of the U.S. equity markets. Our business model focuses on providing comprehensive trade execution services as well as superior client service. To do so, the model requires that we manage risk effectively as well as maintain efficient and reliable trading technology. Substantially all of our Global Markets revenues and profitability come from our operations in the U.S.

Generally, market-makers display the prices at which they are willing to bid, meaning buy, or offer, meaning sell, securities and adjust their bid and offer prices in response to the forces of supply and demand for each security. As a market-maker operating in Nasdaq, the Nasdaq Intermarket, the over-the-counter (OTC) market for New York Stock Exchange (NYSE) and American Stock Exchange (AMEX) listed securities, and the OTC Bulletin Board, we provide trade executions by offering to buy securities from, or sell securities to, institutions and broker-dealers. When acting as principal, we commit our own capital and derive revenues from the difference between the price paid when securities are bought and the price received when those securities are sold. We also provide trade executions on an agency or riskless principal basis, generating commissions or commission equivalents, respectively. We execute the majority of our equity transactions as principal.

Based on rankings published by The AutEx Group, a widely recognized industry reporting service that publishes daily trading volume and market share statistics reported by market-makers, for the year ended December 31, 2005, we had the number one combined market share ranking in share volume in Nasdaq stocks, Nasdaq Small Cap stocks and OTC Bulletin Board stocks. Additionally, based on information published by The AutEx Group for the year ended December 31, 2005, we were ranked number seven in share volume in listed securities on the NYSE and AMEX.

Our domestic Global Markets activities are primarily transacted out of four subsidiaries, Knight Equity Markets, L.P. (KEM), Knight Capital Markets LLC (KCM), Direct Trading Institutional, L.P. (Direct Trading) and Direct Edge ECN LLC (Direct Edge). KEM, KCM, Direct Trading and Direct Edge are all broker-dealers registered with the SEC and are members of the National Association of Securities Dealers (NASD).

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Our international Global Markets activities are primarily operated through Knight Equity Markets International Limited (KEMIL), a U.K. registered broker-dealer authorized and regulated by the Financial Services Authority (FSA) that provides execution services for predominately European institutional and broker-dealer clients in U.S., European and international equities. Our goal is to continue to expand our institutional business and product offerings in Europe in 2006.

Over the past year, we have pursued the following acquisitions of complementary businesses to strengthen our Global Markets business segment and expand our product offerings:

In April 2005, the Company announced that it had reached an agreement to acquire, for cash, the business of Direct Trading, a privately held firm specializing in providing institutions with direct market access trading through an advanced electronic platform. The transaction subsequently closed in June 2005 with a $40 million initial cash payment, and contains a two-year contingency from the date of closing for the payment of additional consideration based on the profitability of the business.

In May 2005, the Company announced that it had reached an agreement to acquire, for cash, the business of the ATTAIN ECN (now operating as Direct Edge), an alternative trading system that operates an electronic communications network (ECN). The Direct Edge ECN provides a liquidity destination with the current ability to match trades in Nasdaq National Market and Nasdaq Small Cap securities by displaying orders in the Nasdaq Market Center or the NASD Alternative Display Facility. The transaction closed in October 2005 with an initial cash payment and contains a four-year contingency from the date of closing for the payment of additional consideration based on meeting certain revenue and client retention metrics.

In January 2006, the Company agreed to acquire Hotspot FX, Inc., an industry-leading electronic foreign exchange marketplace that provides access to electronic foreign exchange spot trade executions through an advanced ECN-based platform, for approximately $77.5 million in cash. The acquisition is expected to close shortly and is subject to customary closing conditions.

Clients and Products

Clients

Within Global Markets, we offer products and provide services to two main client groups: broker-dealers and institutions. Our broker-dealer clients primarily include global, national and regional broker-dealers and on-line brokers. Our institutional clients primarily include mutual funds, pension plans, plan sponsors, hedge funds, trusts and endowments. Based on our internal allocation methodologies, our institutional clients (which include our direct market access, soft dollar and commission recapture clients) generated approximately 60% of our Global Markets revenues in 2005, while our broker-dealer clients generated the remaining 40%.

In 2005, our largest broker-dealer client accounted for approximately 10.7% of the Global Market s U.S. equity dollar value traded. No other client accounted for over 10% of our U.S. equity dollar value traded.

Products and Services

Our strategy for our Global Markets segment is to continue to differentiate ourselves from competitors by providing high quality and competitive trade execution services with superior client service. Over the past three years, we have worked to aggressively expand our offering.

Knight offers institutions comprehensive, unbundled trade execution services covering the depth and breadth of the market. We handle large, complex trades, accessing liquidity from our order flow as well as other sources. When liquidity is not naturally present in the market, we offer capital facilitation to complete our clients trades. Our institutional products include trade execution solutions, block trading, program trading, international equities, special situations/risk arbitrage, soft dollar and commission recapture programs, corporate

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services, technical research and direct market access. During the fourth quarter of 2005, we began to offer all clients our Knight Technical Research product. The majority of our revenues from institutional clients are commissions on agency transactions or commission-equivalents on riskless principal transactions.

We seek to provide broker-dealers with high quality and competitive trade executions that enable them to satisfy their fiduciary obligations to their customers to seek and obtain the best execution reasonably available in the marketplace. Most of our equity order flow comes from providing market-making and execution services to our broker-dealer clients. We execute the majority of the order flow from broker-dealer clients as principal. The majority of the revenues we earn from broker-dealer clients are net trading revenues, generated from the difference between the price paid when securities are bought and the price received when those securities are sold.

Global Markets Competition

The securities industry is constantly evolving and intensely competitive, a trend that we expect will continue. Our market-making product competes primarily with similar products offered by global, national, and regional broker-dealers, the NYSE, the AMEX, regional exchanges and alternative trading venues, such as ECNs. In addition, we have experienced greater competition from market-making firms with highly automated, electronic trading models. Another source of competition comes from broker-dealers who execute portions of their client flow through internal market-making desks rather than sending the client flow to third party execution destinations, such as Knight.

We compete primarily on the basis of our execution standards (including price, liquidity and speed), client relationships, client service, payments for order flow and technology. Over the past several years, regulatory changes, competition and the continued focus by investors on execution quality and overall transaction costs, have resulted in a market environment characterized by narrowed spreads and by reduced revenue capture metrics. Consequently, maintaining profitability has become extremely difficult for many market-makers. Generally, improvements in execution quality, such as faster execution speed and greater price improvement, negatively impact the ability to derive revenues from executing broker-dealer order flow. For example, we have made, and continue to make, changes to our execution protocols, such as voluntarily displaying certain eligible limit orders in OTC Bulletin Board securities in 2005, which has had, or could have, a significant impact on our profitability. To remain profitable, some market-makers have limited or ceased activity in illiquid or marginally profitable securities or, conversely, have sought to execute a greater volume of trades at a lower cost by increasing the automation and efficiency of their operations. In 2005, we significantly increased the amount of automation in our market-making business, and we now execute most of our trades on an automated basis.

In addition, over the past few years, competition for order flow in the U.S. equity markets has intensified due to the implementation of the SEC Rules 11Ac1-5 and 11Ac1-6. These rules, applicable to broker-dealers, add greater disclosure to execution quality and order-routing practices. Rule 11Ac1-5 requires market centers that trade national market system securities to make available to the public monthly electronic reports that include uniform statistical measures of execution quality on a security-by-security basis. Rule 11Ac1-6 requires broker-dealers that route equity and option orders on behalf of their customers to make publicly available quarterly reports that describe their order routing practices and disclose the venues to which customer orders are routed for execution. These statistics on execution quality vary by order sender based on their mix of business. This rule also requires the disclosure of payment for order flow arrangements as well as internalization practices. The intent of this rule is to encourage routing of order flow to destinations based primarily on the demonstrable quality of executions at those destinations, supported by the order entry firms fiduciary obligations to seek to obtain best execution for their customers orders.

Commission rates have been under pressure for a number of years, and the ability to execute trades electronically through the internet and through other alternative trading systems has increased the pressure on trading commissions. It appears that this trend toward alternative trading systems will continue. We may

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experience competitive pressures in these and other areas in the future as some of our competitors seek to obtain market share by reducing prices. Competition for business from institutional clients is based on a variety of factors, including execution quality, equity research, reputation, soft dollar and commission recapture services, technology, client relationships, client service, cost and capital facilitation. Based on industry surveys, approximately 50% of institutional equity commissions have historically been allocated to broker-dealers in exchange for either research or soft dollar and commission recapture services. These industry surveys also indicate that execution quality is one of the primary reasons why institutions allocate commissions to broker-dealers other than for research or soft dollar and commission recapture services. With our acquisition of the business of Donaldson in 2003, we strengthened the soft dollar and commission recapture services we provide to our clients. In 2005, we also established a new research division, Knight Technical Research, to provide unbundled market analysis to our institutional client base. In the future, due partly to the regulatory scrutiny over the past few years relating to equity research and the continued focus by investors on execution quality and overall transaction costs, we believe that a greater percentage of institutional commissions will be allocated based on the quality of executions. However, there is no guarantee that this will occur.

Another factor contributing to the increase in competition for order flow is the announcements in the past year of two significant mergers amongst U.S. market centers. The effects of these mergers will be seen in the coming year as the combined operations commence.

Global Markets Infrastructure

We have invested a significant amount of resources in order to expand our execution capacity and upgrade our trading systems and infrastructure and plan to continue to make additional investments in technology in 2006. Our ability to identify and deploy emerging technologies that facilitate the execution of trades is key to the successful execution of our business model. Not only has technology enhanced our capacity and ability to handle order flow faster, it has also been an important component of our strategy to comply with government regulations, achieve competitive execution standards, increase trading automation and provide superior client service. In order to improve our efficiency and lower costs during 2005, we automated the majority of our execution services for broker-dealer order flow through our internally developed quantitative models. We plan to enhance our use of technology and quantitative models to further automate our execution services.

We use our proprietary technology and technology licensed from third parties to execute trades, monitor the performance of our traders, assess our inventory positions, manage risk and provide ongoing information to our clients. We are electronically linked to institutions and broker-dealers to provide immediate access to our trading operations and to facilitate the handling of client orders. In addition, our business-to-business portal provides our clients with an array of web-based tools to interact with our Global Markets trading systems. Broker-dealers, both foreign and domestic, use this portal to send us order flow, access reports and use the other tools it offers to facilitate their business.

Alternative trading facilities are in place for our domestic Global Markets operations. This facility has been designed to allow us to substantially continue operations if we are prevented from accessing or utilizing our primary office locations for an extended period of time.

Corporate Segment

The corporate segment includes all costs not associated with our two primary operating segments, primarily corporate overhead expenses. 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, investor and public relations expenses and directors and officers insurance. This segment also includes the investment income earned on our strategic investments and our corporate investment in the Deephaven Funds.

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Intellectual Property and Other Proprietary Rights

Our success and ability to compete are dependent to a degree on our intellectual property, which includes our proprietary technology, trade secrets and client base. We rely primarily on trade secret, trademark, domain name, patent and contract law to protect our intellectual property. In addition, it is our policy to enter into confidentiality, intellectual property ownership and/or non-competition agreements with our employees upon commencement of employment, independent contractors and business partners, and to control access to and distribution of our intellectual property.

Government Regulation and Market Structure

Most aspects of the Company s business are subject to extensive securities regulation under federal, state and international laws. In addition, the SEC, the NASD, other self-regulatory organizations (commonly known as SROs), and other regulatory bodies, such as state securities commissions, promulgate numerous rules and regulations. As a matter of public policy, regulatory bodies are charged with safeguarding the integrity of the securities and other financial markets and with protecting the interests of investors in those markets. Broker-dealers, such as KEM, KCM, Direct Trading and Direct Edge, are subject to regulations concerning all aspects of their business, including trade practices, best execution practices, capital structure, record retention and the conduct of officers, supervisors and registered employees. Failure to comply with any of these laws, rules or regulations could result in administrative or court proceedings, censures, fines, the issuance of cease-and-desist orders or injunctions, or the suspension or disqualification of the broker-dealer and/or its officers, supervisors or registered employees. We, and certain of our officers and other employees, have in the past been subject to claims alleging the violation of such laws, rules and regulations. Currently, we are subject to several of these matters as further described in Legal Proceedings in Part I, Item 3 herein. In addition, aspects of the Company s public disclosure, corporate governance principles, internal control environment and the roles of auditors and counsel are subject to the Sarbanes-Oxley Act of 2002 and related regulations and rules of the SEC and The Nasdaq Stock Market, Inc.

Rule-making by the SEC and NASD, and corresponding market structure changes, can have, and have had, an impact on the Company s broker-dealer subsidiaries by directly affecting our method of operation and profitability. In addition, legislation such as the USA Patriot Act of 2001 has imposed significant new obligations on broker-dealers and mutual funds. These increased obligations require the implementation and maintenance of internal practices, procedures and controls which have increased our costs and may subject us to regulatory inquiries, claims or penalties.

The regulatory environment in which we operate our Global Markets business segment is subject to constant change. Our business, financial condition and operating results may be adversely affected as a result of new or revised legislation or regulations imposed by the U.S. Congress, the SEC, other United States or foreign governmental regulatory authorities, the NASD, and other SROs or regulatory bodies. Additional regulations, changes in existing laws and rules, or changes in interpretations or enforcement of existing laws and rules often directly affect the method of operation and profitability of regulated broker-dealers. We cannot predict what effect, if any, such changes might have. For example, in June 2005, the SEC adopted rules under its Regulation NMS designed to modernize and strengthen the regulatory structure of the U.S. equity markets. Although many components of Regulation NMS may strengthen our national market system, certain components of the proposal (i.e., the trade-through rule) may have the potential for causing greater harm than good to the marketplace. Moreover, it is possible that Regulation NMS and its associated rules could negatively impact our Global Markets business. Additionally, the recent proposed expansion of many regional exchanges, in which several exchanges are seeking to create their own alternative trading systems (i.e., ECNs) and compete in the OTC and listed trading venues, could also negatively impact our Global Markets business.

We have foreign based subsidiaries. The brokerage industry in many foreign countries, like the U.S., is heavily regulated. The varying compliance requirements of these different regulatory jurisdictions and other factors may limit our ability to conduct business or expand internationally.

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Our Asset Management subsidiary, Deephaven, recently became registered as an investment adviser with the SEC. Registration as an investment adviser will result in additional responsibilities and obligations on Deephaven s business compared to those prior to registration. Deephaven is also registered with the Commodity Futures Trading Commission (CFTC) and is a member of the National Futures Association (NFA) as a commodity pool operator and a commodity trading adviser. Due to the nature of Deephaven s client base, however, Deephaven is exempt from many of the CFTC/NFA regulations. Deephaven s U.K. subsidiary, Deephaven Capital Management International Ltd., is regulated by the FSA, while Deephaven Asia Limited is regulated by the Hong Kong Securities and Futures Commission.

The Company believes that it is currently in material compliance with applicable regulations.

Net Capital Requirements

Certain of our subsidiaries are subject to the SEC s Net Capital Rule. This rule, which specifies minimum net capital requirements for registered broker-dealers, is designed to measure the general financial integrity and liquidity of a broker-dealer and requires that at least a minimum part of its assets be kept in relatively liquid form. In general, net capital is defined as net worth (assets minus liabilities), plus qualifying subordinated borrowings and certain discretionary liabilities, and less certain mandatory deductions that result from excluding assets that are not readily convertible into cash and from valuing conservatively certain other assets. Among these deductions are adjustments, commonly called haircuts, which reflect the possibility of a decline in the market value of an asset before disposition, and non allowable assets.

Failure to maintain the required net capital may subject a firm to suspension or revocation of registration by the SEC, and suspension or expulsion by the NASD and other regulatory bodies, and ultimately could require the firm s liquidation. The Net Capital Rule prohibits payments of dividends, redemption of stock, the prepayment of subordinated indebtedness and the making of any unsecured advance or loan to a stockholder, employee or affiliate, if such payment would reduce the firm s net capital below required levels.

A change in the Net Capital Rule, the imposition of new rules or any unusually large charges against net capital could limit those operations that require the intensive use of capital and also could restrict our ability to withdraw capital from our broker-dealer subsidiaries. A significant operating loss or any unusually large charge against net capital could adversely affect our ability to expand or even maintain our present levels of business.

Additionally, certain of our foreign subsidiaries are subject to capital adequacy requirements set by their respective regulators.

During 2005, our significant broker-dealer subsidiaries, KEM and KCM, were in compliance with their capital adequacy requirements. For additional discussion related to net capital, see Footnote 19 Net Capital Requirements included in Part II, Item 8 Financial Statements and Supplementary Data of this document.

Employees

As of December 31, 2005, our headcount was 720 full-time employees, compared to 683 full-time employees at December 31, 2004. The increase in headcount is primarily related to expansion of our Global Markets offering through the addition of the businesses of Direct Trading and Direct Edge in 2005. Of our 720 full-time employees at December 31, 2005, 659 were employed in the U.S. and 61 outside the U.S., primarily in the United Kingdom. None of our employees is subject to a collective bargaining agreement. We believe that our relations with our employees are good.

Item 1A. ***Risk Factors***

We face a number of risks that may adversely affect our business, financial condition and operating results. These include, but are not limited to, the following:

Our business could be harmed by adverse economic, political and market conditions

The securities business generally is, by its nature, volatile. It is directly affected by numerous national and international factors that are beyond our control, including, among others, economic and political conditions; market sentiment; the availability of short-term and long-term funding and capital; the level and volatility of interest rates; legislative and regulatory changes; changes in currency and commodity values and inflation. In addition, events such as the terrorist attacks in the United States in 2001 and subsequent U.S. military actions have impacted the U.S. securities markets. Any one or more of these factors may contribute to reduced levels of activity in the securities markets generally, or increased market volatility, which could result in lower revenues in both our Global Markets and Asset Management segments. Any reduction in revenues or any loss resulting from the above factors could have a material adverse effect on the Company s businesses, financial condition and operating results.

Regulatory and legal uncertainties could harm our business

The securities industry in the United States is subject to extensive oversight under federal, state and applicable international laws as well as SRO rules. Broker-dealers are subject to regulations concerning all aspects of their business, including trade practices, best execution practices, capital structure, record retention and the conduct of their officers, supervisors and registered employees. Our operations and profitability may be directly affected by, among other things, additional legislation; changes in rules promulgated by the SEC, the NASD, the FSA and other SROs or regulatory bodies; and changes in the interpretation or enforcement of existing laws and rules. Failure to comply with these laws, rules or regulations could result in, among other things, administrative or court proceedings, censure, fines, the issuance of cease-and-desist orders or injunctions or the suspension or disqualification of the broker-dealer or asset manager and/or their officers, supervisors or registered employees. Our ability to comply with applicable laws and rules is largely dependent on our internal system to ensure compliance, as well as our ability to attract and retain qualified compliance personnel. We are now the subject of regulatory reviews and investigations that may result in disciplinary actions in the future due to claimed noncompliance.

In addition, various regulatory and enforcement agencies have been reviewing regulatory reporting obligations and best execution and trading practices as they relate to the brokerage and options industries. These reviews could result in enforcement actions or new regulations which could adversely affect our operations.

The SEC, NASD and SROs are constantly proposing, or enacting, new regulations for the marketplace. For example, in June 2005, the SEC adopted rules under its Regulation NMS designed to modernize and strengthen the regulatory structure of the U.S. equity markets. Although many components of Regulation NMS may strengthen our national market system, certain components of the proposal (e.g., the trade-through rule) may have the potential for creating greater harm than good to the marketplace. Moreover, it is possible that Regulation NMS, and its associated rules, could negatively impact our Global Markets business.

In regards to our Asset Management business, market disruptions and the dramatic increase in the capital allocated to alternative investment strategies during recent years have led to increased governmental as well as self-regulatory scrutiny of the hedge fund industry in general, and certain legislation proposing greater regulation of the industry periodically is considered or adopted by the U.S. Congress, as well as the

Department of Labor, which enforces the Employee Retirement Income Security Act of 1974 to which Deephaven is subject, and certain U.S. regulatory entities and the governing bodies of non-U.S. jurisdictions. For example, the SEC has enacted new rules that required most investment advisers to hedge funds, including Deephaven, to register as investment advisers by February 1, 2006 which will result in additional responsibilities and obligations on Deephaven s business. Deephaven became a registered investment advisor in January 2006. It is impossible to predict what, if any, changes in regulation applicable to Deephaven or the funds it manages, the markets in which they trade and invest or the counterparties with whom they do business may be instituted in the future. Any such regulation could negatively impact the profit potential of our Asset Management business.

As a result, regulatory actions or proceedings, regulatory legislation and changes in market customs and practices could have a material adverse effect on the Company s business, financial condition and operating results.