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 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.

We are highly dependent on key personnel

We are highly dependent on a limited number of key executives. Except for Thomas Joyce, our Chairman of the Board and Chief Executive Officer, who has an employment contract through December 2008, and the Deephaven managers, no other key executive has an employment contract with the Company. Our success will be dependent to a large degree on our ability to retain the services of our existing key executives and to attract and retain additional qualified personnel in the future. Competition for such personnel is intense. The loss of the services of any of our key executives or the inability to identify, hire and retain necessary highly qualified executive management in the future could have a material adverse effect on our business, financial condition and operating results.

The Deephaven managers have entered into employment agreements, which became effective on January 1, 2004. These agreements 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. In the event that these agreements are not renewed by the Deephaven managers and we lose the services of any of these senior managers, it could have a material adverse effect on our business, financial condition and operating results.

Our success also depends, in part, on the highly skilled, and often specialized, individuals we employ. Our ability to attract and retain management, sales, trading and technology professionals is important to our business strategy. The Company strives to provide high quality services that will allow it to establish and maintain long-term relationships with its clients. The Company s ability to do so depends, in large part, upon the individual employees who represent the Company in its dealings with such clients. There can be no assurance that the Company will not lose such professionals due to increased competition or other factors in the future. The loss of sales, trading or technology professionals, particularly senior professionals with broad industry expertise, could have a material adverse effect on the Company s business, financial condition and operating results.

Risk of losses associated with our Global Markets and Asset Management businesses

We conduct our market-making activities predominantly as principal, which subjects our capital to significant risks. These activities involve the purchase, sale or short sale of securities for our own account and, accordingly, involve risks of price fluctuations and illiquidity, or rapid changes in the liquidity of markets that may limit or restrict our ability to either resell securities we purchase or to repurchase securities we sell in such transactions. From time to time, we may have large position concentrations in securities of a single issuer or issuers engaged in a specific industry, which might result in higher trading losses than would occur if our positions and activities were less concentrated. The success of our market-making activities primarily depends upon our ability to attract order flow, the amount of, and volatility in, our quantitative market-making and program trading portfolios, the performance of our quantitative market-making models, the skill of our trading personnel, general market conditions, effective hedging strategies, the price volatility of specific securities and the availability of capital. To attract order flow, we must be competitive on price, size of securities positions traded, liquidity offerings, order execution speed, technology, reputation and client relationships and service. In our role as a market-maker, we attempt to derive a profit from the difference between the prices at which we buy and sell securities. However, competitive forces often require us to match the quotes other market-makers display and to hold varying amounts of securities in inventory. By having to maintain inventory positions, we are subject to a high degree of risk. There can be no assurance that we will be able to manage such risk successfully or that we will not experience significant losses from such activities. All of the above factors could have a material adverse effect on our business, financial condition and operating results.

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The strategies employed by our Asset Management business could result in substantial risk of loss both to investors and to the Company s corporate investment in the Deephaven Funds. In addition, as the Asset Management business employs leverage as an integral part of its various strategies, the risk of loss and the volatility of the underlying Deephaven Funds portfolios are increased. There can be no assurance that we will be able to manage such risk successfully or that we will not experience significant losses from such activities which could have a material adverse effect on our business, financial condition and operating results.

Our future operating results may fluctuate significantly

We may experience significant variation in our future results of operations. These fluctuations may result from, among other things, introductions of or enhancements to trade execution services by us or our competitors; the value of our securities positions and our ability to manage the risks attendant thereto; the volume of our market-making activities; the dollar value of securities traded; volatility in the securities markets; our market share with institutional and broker-dealer clients; the performance, amount of, and volatility in, our quantitative market-making and program trading portfolios; the performance of our international operations; our ability to manage personnel, overhead and other expenses, including our occupancy expenses under our office leases and expenses and charges relating to legal and regulatory proceedings; the strength of our client relationships; changes in payments for order flow and clearing, execution and regulatory transaction costs; the level of assets under management and fund returns; the addition or loss of executive management and asset management, sales, trading and technology professionals; legislative, legal and regulatory changes; legal and regulatory matters; geopolitical risk; the amount and timing of capital expenditures, acquisitions and divestitures; integration, performance and operation of acquired businesses; the incurrence of costs associated with acquisitions and dispositions; investor sentiment; technological changes and events; seasonality; competition; and market and economic conditions. Such factors may also have an impact on our ability to achieve our strategic objectives, including, without limitation, increases in our market share and revenue capture in our Global Markets segment, and increases in our fund returns and assets under management in our Asset Management segment. If demand for our services declines in either of our two operating business segments due to any of the above factors, and we are unable to adjust our cost structure on a timely basis, our operating results could be materially and adversely affected. There also can be no assurance that we will be able to return to the rates of revenue growth that we have experienced in the past or, that we will be able to improve our operating results.

At December 31, 2005, the Company held a corporate investment of approximately $282 million in the Deephaven Funds. A decline in the Deephaven Funds returns could also have a material adverse effect on the value of our corporate investment and our operating results.

Our Asset Management business is subject to many risks

Our Asset Management business is subject to a variety of risks. These risks include, but are not limited to, the departure of key management, redemptions by investors, volatility of the funds returns and regulatory or legislative changes and proceedings. Currently, approximately 50% of the Deephaven Funds assets under management are within the Market Neutral Fund which employs market neutral investment strategies intended to focus on the preservation of capital. The general objective of market neutral investment strategies is to seek to capture mispricings or spreads between related capital instruments. Because the primary basis of the Deephaven Funds market neutral strategy is capturing 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. However, there will be unhedged credit risk in the convertible arbitrage portfolio and that part of the portfolio will have some correlation to credit spreads. Market neutral trading strategies also involve other substantial risks such as, the disruption in historical pricing relationships and the risk of a tightening of dealer credit, forcing the premature liquidation of positions. The Deephaven Funds also employ single-strategy funds that are not market neutral focused. These single-strategy funds pursue investment strategies which involve substantial risks based on the fact that they are concentrated strategies and could be adversely affected by structural economic and regulatory changes, or general market conditions. The concentrated focus of these strategies may cause their performance to be more volatile and result in the incurrence of greater losses during unprofitable periods as compared to a more diversified approach.

Clients of our Asset Management business may generally redeem their investments upon relatively short notice, subject to certain withdrawal restrictions. In a declining market, the pace of these redemptions and withdrawal of assets may accelerate. Poor performance relative to other investment management firms also tends to result in increased redemptions, the loss of accounts, and potentially significant limitations on Deephaven s ability to raise new assets. In addition, regulatory proceedings can impact the ability to raise funds and may increase redemptions. These redemptions could have a material adverse effect on the value of our investment in the Deephaven Funds and our results of operations. Separately, Deephaven s business also involves specific categories of trading and operational risk. For example, although Deephaven attempts to hedge positions as part of its trading strategies, there is no assurance that adequate hedging opportunities will exist. Moreover, Deephaven relies to a material degree on its prime brokers to provide leverage, custody, execution and other services, but there is no assurance that the prime brokers will continue to provide the amount of leverage which they have in the past, or on the same terms, or provide any of the other services they currently provide, on a cost-effective basis. Deephaven also faces significant risk from the fact that any of its trading counter-parties could fail, which would likely have the effect of greatly diminishing the value of the assets which are the subject of trades with that counterparty. Finally, if Deephaven does not appropriately structure its use of leverage, the losses the funds incur could be materially exacerbated.

Substantial competition could reduce our market share and harm our financial performance

We derive substantially all of our revenues from Global Markets and Asset Management activities. The market for these services is constantly evolving and intensely competitive, a trend that we expect will continue. We face direct competition in our Global Markets business primarily from global, national and regional broker-dealers, and also alternative trading systems, including other ECNs. Competition is primarily on the basis of our execution standards (including price, liquidity and speed), client relationships, reputation, product and service offerings and technology. A number of our Global Markets competitors have greater financial, technical, marketing and other resources than we do. Some of our competitors offer a wider range of services and financial products than we do and have greater name recognition and a more extensive client base. These competitors may be able to respond more quickly than us to new or evolving opportunities and technologies, market changes, and client requirements and may be able to undertake more extensive promotional activities and offer more attractive terms to clients. Moreover, current and potential competitors have established or may establish cooperative relationships among themselves or with third parties or may consolidate to enhance their services and products. It is possible that new competitors, or alliances among competitors, may also emerge and they may acquire significant market share.

In our Asset Management business we primarily compete with hedge funds and other asset management companies. Competition is based primarily on our reputation, client relationships, the experience and stability of the management team, investment strategies, leverage, risk profile, fee structures and historical fund returns. Many of our competitors may have substantially greater financial resources as well as larger research and trading staffs than those available to Deephaven. These greater resources may be a particularly important competitive advantage given the highly technical, quantitative analysis required by market neutral trading, the strategy in which approximately 50% of the Deephaven Funds assets under management are invested. Competitive investment activity by other firms tends to reduce the Deephaven Funds opportunity for profit by reducing mispricings in the market as well as the margins available on the mispricings which can still be identified. In addition, the amount of capital committed to alternative investment strategies (i.e., hedge funds) has increased dramatically during recent years. At the same time, market conditions have become significantly more adverse to many of these strategies than they were in previous years. The profit potential of the Deephaven Funds may be materially reduced as a result of the proliferation of alternative investment entities in competition with Deephaven.

As a result of the above, there can be no assurance that we will be able to compete effectively with current or future competitors, which could have a material adverse effect on our business, financial condition and operating results.

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We could lose significant sources of revenues if we lose any of our major clients

At times, a limited number of Global Markets clients have accounted for a significant portion of our equity and institutional order flow, and we expect a large portion of the future demand for our Global Markets trading and market-making services to remain concentrated within a limited number of clients. None of our clients is contractually obligated to utilize us as a market-maker and, accordingly, these clients may direct their trading activities to other market-makers at any time. Some of these clients have purchased market-makers and specialist firms to internalize order flow. There can be no assurance that we will be able to retain these major clients or that such clients will maintain or increase their demand for our trading and market-making activities. In 2005, one client accounted for 10.7% of our total U.S. equity dollar value traded in our Global Markets segment. Our Asset Management segment also has a limited number of investors. At December 31, 2005, there was one institution that accounted for 10.1% of the Deephaven Funds assets under management. The loss, or a significant reduction, of demand for our services from any of these clients could have a material adverse effect on our business, financial condition and operating results.

Our business is subject to substantial risk from litigation, regulatory investigations and potential securities laws liability

Many aspects of our business involve substantial risks of liability. We are exposed to liability under federal and state securities laws, other federal and state laws and court decisions, as well as rules and regulations promulgated by the SEC, the NASD, the Department of Labor, the FSA and other U.S. and non-U.S. SROs and regulatory bodies. We are also subject to the risk of litigation. We, and certain of our past and present officers, directors and employees, have been named as parties in legal actions, regulatory investigations and proceedings, securities arbitrations and administrative claims in the past and have been subject to claims alleging the violation of such laws, rules and regulations, some of which have resulted in the payment of fines and settlements. Moreover, the Company may be required to indemnify past and present officers, directors and employees in regards to these matters. Currently, we are subject to several of these matters as further described in Legal Proceedings in Part I, Item 3 herein.

In addition, certain corporate events, such as a reduction in our workforce, could also result in additional litigation or arbitration. As we intend to defend vigorously any such litigation or proceeding, significant legal expenses could be incurred. An adverse resolution of any current or future lawsuits, legal or regulatory proceedings or claims against us could have a material adverse effect on the Company s business, financial condition and operating results.

Acquisitions, strategic investments and strategic relationships involve certain risks

Over the last year, we have undertaken several strategic acquisitions, including the completed acquisitions of Direct Trading and Direct Edge and the pending acquisition of Hotspot FX, Inc. We intend to continue to pursue strategic acquisitions of, or investments in, businesses and technologies. Acquisitions may entail numerous risks, including difficulties in assessing values for acquired businesses and technologies, difficulties in the assimilation of acquired operations and products, diversion of management s attention from other business concerns, assumption of unknown material liabilities of acquired companies, amortization of acquired intangible assets which could reduce future reported earnings, and potential loss of clients or key employees of acquired companies. We may not be able to integrate successfully any operations, personnel, services or products that we have acquired or may acquire in the future. Strategic investments may also entail some of the risks described above. If these investments are unsuccessful, we may need to incur a charge against earnings. We have also established a number of strategic relationships. These relationships and others we may enter into in the future may be important to our business and growth prospects. We may not be able to maintain these relationships or develop new strategic alliances.

Our revenues may be negatively impacted by declines in market volume, price or liquidity

Our Global Markets revenues may decrease in the event of a decline in market volume, prices or liquidity. Declines in the volume of securities transactions and in market liquidity generally result in lower revenues from

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market-making activities. Lower price levels of securities may also result in reduced revenue capture, and thereby reduced revenues from market-making transactions, as well as result in losses from declines in the market value of securities held in inventory. Sudden sharp declines in market values of securities can result in illiquid markets, declines in the market values of securities held in inventory, the failure of buyers and sellers of securities to fulfill their obligations and settle their trades, and increases in claims and litigation. Our Asset Management business could be similarly impacted. Any decline in market volume, price or liquidity or any other of these factors could have a material adverse effect on our business, financial condition and operating results.

Our revenues may be negatively impacted by factors that adversely affect our trade execution activities and the credit risks associated with our clearing brokers

The majority of our revenues are derived from our Global Markets business. We expect this to continue for the foreseeable future. Any factor adversely affecting trading and market-making in general, or our market-making activities in particular, could adversely affect our business, financial condition and operating results. Our future success will depend on continued demand for our trading and market-making services and our ability to respond to regulatory and technological changes, as well as client demands. If demand for our trading and market-making services fails to grow, grows more slowly than we currently anticipate, or declines, our business, financial condition and operating results could be materially and adversely affected.

As a market-maker of OTC and listed equities, the majority of our securities transactions are conducted as principal with broker-dealer and institutional counterparties located in the United States. We clear the majority of our securities transactions through unaffiliated clearing brokers. Under the terms of the agreements between us and our clearing brokers, the clearing brokers have the right to charge us for losses that result from a counterparty s failure to fulfill its contractual obligations. No assurance can be given that any such counterparty will not default on its obligations, which default could have a material adverse effect on our business, financial condition and operating results. In addition, at any time, a substantial portion of our assets are held at one or more clearing brokers and, accordingly, we are subject to credit risk with respect to such clearing brokers. One firm clears the majority of our trades and holds the majority of our assets within Global Markets. Consequently, we are reliant on the ability of our clearing brokers to adequately discharge their obligations on a timely basis. We are also dependent on the solvency of such clearing brokers. Any failure by the clearing brokers to adequately discharge their obligations on a timely basis, or failure by a clearing broker to remain solvent, or any event adversely affecting the clearing brokers, could have a material adverse effect on our business, financial condition and operating results.

The market price of our common stock could fluctuate significantly

Our Class A Common Stock, and the U.S. securities markets in general, have experienced significant price fluctuations in recent years. The price of our Class A Common Stock could decrease substantially. In addition, because the market price of our Class A Common Stock tends to fluctuate significantly, we may become the object of securities class action litigation which may result in substantial costs and a diversion of management s attention and resources. In addition, our future quarterly operating results may not consistently meet the expectations of securities analysts or investors, which could have a material adverse effect on the market price of our Class A Common Stock.

Capacity constraints, systems failures and delays could harm our business

Our business activities are heavily dependent on the integrity and performance of the computer and communications systems supporting them and the services of certain third parties. Our systems and operations are vulnerable to damage or interruption from human error, natural disasters, power loss, computer viruses, intentional acts of vandalism and similar events. Extraordinary trading volumes or other events could cause our computer systems to operate at an unacceptably low speed or even fail. While we have invested significant amounts of capital in the last few years to upgrade the capacity, reliability and scalability of our systems, there can be no assurance that our systems will be sufficient to handle such extraordinary trading volumes. Many of our systems are, and much of our infrastructure is, designed to accommodate additional growth without redesign

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or replacement; however, we may need to make significant investments in additional hardware and software to accommodate growth. Failure to make necessary expansions and upgrades to our systems and infrastructure could lead to failures and delays. Such failures and delays could cause substantial losses for our clients and could subject us to claims from our clients for losses, including litigation claiming fraud or negligence. In the past, high trading volume has caused significant delays in executing some trading orders, resulting in some clients orders being executed at prices they did not anticipate. From time to time, we have reimbursed our clients for losses incurred in connection with systems failures and delays.

Capacity constraints, systems failures and delays may occur again in the future and could cause, among other things, unanticipated disruptions in service to our clients, slower system response times resulting in transactions not being processed as quickly as our clients desire, decreased levels of client service and client satisfaction, and harm to our reputation. If any of these events were to occur, we could suffer a loss of clients or a reduction in the growth of our client base, increased operating expenses, financial losses, additional litigation or other client claims, and regulatory sanctions or additional regulatory burdens.

In addition, we have developed business continuity capabilities that can be utilized in the event of a disaster or disruption. Since the timing and impact of disasters and disruptions are unpredictable, we have to be flexible in responding to actual events as they occur. Significant business disruptions can vary in their scope. A disruption might only affect the Company, a building housing the Company, a business district in which the Company is located, a city in which the Company is located or an entire region. Within each of these areas, the severity of the disruption can also vary from minimal to severe. The Company s business continuity facilities are designed to allow us to substantially continue operations if we are prevented from accessing or utilizing our primary offices for an extended period of time. While the Company has employed significant steps to develop, implement and maintain reasonable business continuity plans, the Company cannot guarantee our systems will absolutely recover after a significant business disruption. If we are prevented from using any of our current trading operations or if our business continuity operations do not work effectively, we may not have complete business continuity. This could have a material adverse effect on our business, financial condition and operating results.

We may not be able to keep up with rapid technological and other changes

The markets in which we compete are characterized by rapidly changing technology, evolving industry standards, frequent new product and service announcements, introductions and enhancements and changing client demands. If we are not able to keep up with these rapid changes on a timely and cost-effective basis, we may be at a competitive disadvantage. In addition, the widespread adoption of new internet, networking or telecommunications technologies or other technological changes could require us to incur substantial expenditures to modify or adapt our services or infrastructure. Any failure by us to anticipate or respond adequately to technological advancements, client requirements or changing industry standards, or any delays in the development, introduction or availability of new services, products or enhancements could have a material adverse effect on our business, financial condition and operating results.

Item 1B. ***Unresolved Staff Comments***

None.

Item 2. ***Properties***

Our corporate headquarters are located in Jersey City, New Jersey. We lease approximately 266,000 square feet at 545 Washington Boulevard under a lease that expires in October 2021. We also lease approximately 108,000 square feet at 525 Washington Boulevard, our former headquarters, under a lease that expires in April 2006. We also collectively lease approximately 121,000 square feet for our offices in Atlanta, GA; Boston, MA; Chicago, IL; Garden City, NY; Minnetonka, MN; New York, NY; Purchase, NY; Red Bank, NJ; Irving, TX; San Francisco, CA; Santa Monica, CA; Santa Clara, CA; Hong Kong, China; and London, England.

The Company incurred an additional $10.1 million of Writedown of assets and lease loss accruals in 2005. A loss of $5.5 million is related to the lease loss accrual on a portion of our lease at 545 Washington Boulevard in Jersey City, N.J., encompassing approximately 78,000 square feet, all of which is unoccupied. The Company engaged a real estate broker to sub-lease this excess space, but to date our efforts to sub-let this space have not been successful. This accrual was derived from assumptions and estimates based on lease terms of an anticipated sub-lease agreement, which assumed a sub-lease would commence in the beginning of 2007, anticipated market prices along the Jersey City waterfront and estimated up-front costs, including broker fees and build-out allowances. We continually monitor the market and space to assess the reasonableness of our applicable assumptions.

A loss of $3.7 million is related to the lease loss accrual on the excess real estate capacity at our former headquarters at 525 Washington Boulevard, Jersey City, N.J. The lease on this location ends in April 2006 and we abandoned this location in the second quarter of 2005.

Item 3. ***Legal Proceedings***

From time to time, we and certain of our past and present officers, directors and employees have been named as parties to legal actions, securities arbitrations, administrative claims and regulatory reviews and investigations arising in connection with the conduct of our businesses. We are also subject to several of these matters at the present time. Although there can be no assurances, at this time the Company believes, based on information currently available, that the outcome of each of the matters will not have a material adverse effect on the consolidated financial condition of the Company, although they might be material to operating results for any particular period, depending, in part, upon operating results for that period.

Legal

Short Selling Litigation KEM and/or the Company, sometimes together with other broker-dealer defendants, have been named in actions in which it was generally alleged that the firm improperly engaged in short sales transactions concerning securities of certain issuers. In general, the plaintiffs in all of these lawsuits are limited to either the issuer and/or a shareholder of the underlying security. Certain of these cases have been dismissed and others are in various stages of the litigation process. The one case currently pending is *H-Quotient, Inc. v. Knight Trading Group, Inc. and Knight Securities, L.P.* in the United States District Court for the Southern District of New York. In *Sporn et al. v. Elgindy et al,* which had been filed in the United States District Court for the Central District of California, the court dismissed, with prejudice, the claims against the Company, and the plaintiffs have filed a notice of appeal in the Ninth Circuit Court of Appeals. The Ninth Circuit remanded the case to the District Court on the grounds that there was no final appealable judgment. The plaintiffs have also filed an amended complaint. In *ATSI v. The Shaar Fund, Ltd. Et al.,* which had been pending in the United States District Court for the Southern District of New York, the court dismissed, with prejudice, the claims against the Company, and the plaintiffs have filed a notice of appeal in the Second Circuit.

KEM Trading Dispute Arbitration On February 28, 2005, KEM filed an arbitration claim with NASD Dispute Resolution, Inc. against a trading counterparty and one of its registered representatives seeking recovery of approximately $6.5 million, representing the amount KEM believes it is owed by this counterparty in a trading dispute regarding the counterparty s receipt of dividends on stocks traded for same-day settlement during the ex-dividend period (the KEM Trading Dispute Arbitration). In March 2005, a customer of the counterparty in the KEM Trading Dispute Arbitration filed an action in New York State Supreme Court against KEM seeking declaratory relief that the customer is the rightful owner of the dividends paid to them. In August 2005, the New York State Supreme Court granted KEM s motion to dismiss the declaratory action and the customer filed a notice of appeal from that dismissal in September 2005. In October 2005, KEM s counterparty asserted claims in the KEM Trading Dispute Arbitration in the nature of an interpleader against its customer and KEM, requesting that the panel determine the rights to the disputed dividends.

Last Atlantis Capital LLC et al. v. Chicago Board Options Exchange, Inc. et al. In January 2004, thirty-five securities firms, including the Company and its former operating subsidiary, Knight Financial Products LLC (collectively the market-maker defendants), as well as four options exchanges, were named in a complaint filed in the United States District Court for the Northern District of Illinois. The plaintiffs in the action allegedly submitted orders to buy and sell options on the four named options exchanges, and the market-maker defendants were prospective and/or actual counterparties to those orders. The plaintiffs allege that during the period from September 11, 2000 through the present day the market-maker defendants, among other things, failed to provide a competitive and orderly market for the purchase and sale of the options and issued false and misleading price quotations that deceived the plaintiffs. The plaintiffs allege that this conduct violated certain sections of the Sherman and Clayton Acts, the federal securities laws and Illinois state law, and also should result in common law liability. The plaintiffs have requested unspecified monetary damages and injunctive relief. On or about March 30, 2005, the court dismissed the complaint with prejudice and entered judgment against the plaintiffs. Plaintiffs moved to vacate the judgment and for reconsideration of the dismissal. The court then permitted plaintiffs to file an amended complaint and to add additional parties as plaintiff. Defendants have moved to dismiss the amended complaint.

Gurfein etc. v. Ameritrade, Inc. et al. This putative class action was filed in the United States District Court for the Southern District of New York in December 2004, alleging that the Company, various specialist firms, broker-dealers and the American Stock Exchange violated common law and the securities laws by, among other things, failing to execute limit orders for options at quoted prices and by executing market orders for options at prices less favorable than the actual market price. The plaintiff seeks unspecified monetary damages and injunctive relief. The Company is seeking indemnification for this matter under contractual arrangements with a third party, although there is no guarantee that it will be successful in obtaining such indemnification. On January 26, 2006, the court dismissed the case with prejudice against the American Stock Exchange and without prejudice against the remaining defendants.

Regulatory

The Company owns subsidiaries including regulated broker-dealers that are subject to extensive oversight under federal, state and applicable international laws as well as SRO rules. Changes in market structure and the need to remain competitive require constant changes to our systems and order handling procedures. The Company makes these changes while continuously endeavoring to comply with many complex laws and rules. Compliance, surveillance or trading issues, common in the securities industry, and which are monitored or reported to the SEC or SROs, are reviewed in the ordinary course of business by our primary regulators, the SEC and the NASD. The Company, as a major order flow execution destination, is named from time to time in, or is asked to respond to a number of regulatory matters brought by SROs that arise from its trading activity. The Company is currently the subject of various regulatory reviews and investigations. In some instances, these matters may rise to an SEC or SRO disciplinary action and/or civil or administrative action.

As disclosed in the Company s Form 8-K filing on June 27, 2005, Deephaven announced that it and a former Deephaven employee had received Wells Notices from the staff of the Division of Enforcement of the SEC. The Wells Notice to Deephaven indicated that the staff was considering recommending that the Commission bring a civil injunctive action against Deephaven alleging that Deephaven violated the anti-fraud provisions of the securities laws in connection with trading activity associated with certain Private Investments in Public Equities (PIPEs). On February 9, 2006, in a Form 8-K filing made by the Company, Deephaven announced that it had submitted an offer of settlement to the staff of the SEC, which the staff has agreed to recommend to the Commission, to resolve the investigation covered by the Wells Notice received by Deephaven. The offer of settlement is subject to final agreement on the settlement papers and final approval by the Commission.

Under the terms of the offer of settlement, Deephaven would disgorge approximately $2.7 million, pay approximately $343,000 in pre-judgment interest and pay approximately $2.7 million as a civil penalty. The offer of settlement, if approved by the SEC, would involve the filing by the SEC of a civil complaint in Federal District Court, in which it would be alleged that Deephaven traded in possession of material non-public information concerning 19 PIPEs offerings. The complaint would allege violations of the anti-fraud provisions of Section 17(a) of the Securities Act of 1933 and Section 10(b) of the Securities Exchange Act of 1934 and

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Rule 10b-5 thereunder. Without admitting or denying the allegations in the SEC s complaint, and as part of the settlement, Deephaven would be permanently enjoined from violating these provisions of law. During 2005, the Company recorded a $5.7 million pre-tax charge relating to this matter.

The offer of settlement, if approved by the SEC, would resolve the matters for which Deephaven received a Wells Notice from the staff of the SEC.

As disclosed in our amended Annual Report on Form 10-K/A for the year ended December 31, 2004, on December 16, 2004, Knight Securities L.P., (KSLP, now known as KEM) concluded a settlement with the SEC and the NASD (the Settlement). The Settlement resolved the matters for which KSLP received Wells Notices from the staffs of the SEC and NASD but did not address Wells Notices received by certain former employees of KSLP. On March 7, 2005, NASD announced that it had charged Kenneth Pasternak, former CEO of KSLP, and John Leighton, former head of KSLP s institutional sales desk, in an administrative complaint alleging supervisory violations in connection with fraudulent sales to institutional customers in 1999 and 2000. On August 8, 2005, the SEC announced that it had filed a civil fraud action in the United States District Court for the District of New Jersey against Kenneth Pasternak and John Leighton.

The foregoing description of the Settlement is qualified in its entirety by the full text of the SEC s Order and the Letter of Acceptance, Waiver and Consent with NASD, which were attached as exhibits to the Company s Form 8-K filed on December 17, 2004.

Lastly, the Company has received a request from the staff of the SEC for certain documentation related to options activities of its subsidiary, Knight Financial Products LLC, during the period of time that the subsidiary conducted the Derivative Markets business prior to its sale by the Company. The Company believes this request is part of a broader review by the staff of the SEC regarding certain trading practices in the options industry during the period 1999-2005. The Company is responding to this documentation request and is in preliminary discussions with the staff of the SEC to resolve this matter.

Other Matters

In addition to the matters described above, in the normal course of business, the Company has been named, from time to time, as a defendant or respondent in various legal actions, including arbitrations, class actions, and other litigation, arising in connection with its business activities as a consolidated group of regulated broker-dealers providing execution and trading services. Certain of these legal actions include claims for substantial compensatory and/or punitive damages or claims for indeterminate amounts of damages. From time to time, Deephaven may be a plaintiff in suits filed in federal or state courts taken in support of activist or other investments made by one of the funds managed by Deephaven. In view of the inherent difficulty of predicting the outcome of such matters, particularly in cases in which claimants seek substantial or indeterminate damages, the Company cannot predict with certainty the eventual loss, or range of loss, or the range of potential recovery, related to such matters. The Company is contesting liability and/or the amount of damages in each pending matter.

Item 4. ***Submission of Matters to a Vote of Security Holders***

None.

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PART II

Item 5. ***Market for Registrant s Common Equity and Related Stockholder Matters***

Our Class A Common Stock is traded on the Nasdaq National Market under the symbol NITE. Public trading of our Class A Common Stock commenced on July 8, 1998. The following table sets forth, for the past two years, the high and low quarterly sales price per share of the Class A Common Stock in the Nasdaq National Market:

2005	High	Low
First Quarter	$ 10.99	$ 9.35
Second Quarter	9.69	7.28
Third Quarter	8.94	7.40
Fourth Quarter	10.90	7.87
2004		
First Quarter	17.27	11.20
Second Quarter	13.53	9.65
Third Quarter	10.30	8.06
Fourth Quarter	12.19	9.13

The closing sale price of our Class A Common Stock as reported on the Nasdaq National Market on March 13, 2006, was $13.71 per share. As of that date there were approximately 583 holders of record of our Class A Common Stock based on information provided by the transfer agent. The number of stockholders does not reflect the actual number of individual or institutional stockholders that hold our stock because certain stock is held in the name of nominees. Based on information made available to us by the transfer agent, there are approximately 36,500 beneficial holders of our Class A Common Stock.

We have never declared or paid a cash dividend on our Class A Common Stock. The payment of cash dividends is within the discretion of our Board of Directors and will depend on many other factors, including, but not limited to, our results of operations, financial condition, capital requirements, restrictions imposed by financing arrangements, general business conditions and legal requirements.

The following table contains information about our purchases of Class A Common Stock during the fourth quarter of 2005:

Period(1)	Total Number of Shares Purchased	Average Price Paid per Share	Total Number of Shares Purchased as Part of Publicly Announced Plans or Programs(2)	Approximate Dollar Value of Shares That May Yet Be Purchased Under the Plans or Programs
October 1, 2005 - December 31, 2005		$		$ 49,059,900

(1) As a matter of policy, the Company does not repurchase its Class A Common Stock during self-imposed closed window periods.

(2) On April 4, 2002, the Company s Board of Directors announced the authorization of a stock repurchase program, which allowed for the purchase of Class A Common Stock up to a total amount of $35 million. This repurchase program was increased by an aggregate of $310 million to a total of $345 million by resolutions of the Company s Board of Directors adopted on July 16, 2002, May 12, 2003, April 20, 2004, August 8, 2004, April 19, 2005 and October 18, 2005. The Company may repurchase shares in the open market or through privately negotiated transactions, depending on prevailing market conditions, alternative use of capital and other factors. The repurchase program has no set expiration or termination date. During the fourth quarter of 2005, the Company did not repurchase any additional shares under the program.

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Item 6. ***Selected Financial Data***

The following selected consolidated financial data are qualified by the Consolidated Financial Statements of Knight Capital Group, Inc. and the Notes thereto included elsewhere in this document. The following should be read in conjunction with the Consolidated Financial Statements and the discussion under Item 7. Management s Discussion and Analysis of Financial Condition and Results of Operations included elsewhere in this document. The Consolidated Statements of Operations Data for 2005, 2004 and 2003 and the Consolidated Statements of Financial Condition Data at December 31, 2005 and 2004 have been derived from our audited Consolidated Financial Statements included elsewhere in this document. The Consolidated Statements of Operations Data for 2002 and 2001 and the Consolidated Statements of Financial Condition Data at December 31, 2003, 2002 and 2001 are derived from Consolidated Financial Statements not included in this document.

	For the years ended December 31,				
	2005	2004	2003	2002	2001
Consolidated Statements of Operations Data (1):	(In thousands, except share and per share data)				
Revenues					
Commissions and fees	$ 296,222	$ 276,011	$ 163,147	$ 75,599	$ 28,633
Net trading revenue	165,614	250,993	290,938	269,323	451,877
Asset management fees	89,227	77,658	57,903	34,510	36,757
Interest and dividends, net	9,019	4,647	3,657	5,357	16,505
Investment income and other	74,541	16,441	30,264	13,199	8,521
Total revenues	634,623	625,750	545,909	397,988	542,293
Transaction-based Expenses					
Execution and clearance fees	99,427	111,788	102,659	85,917	96,305
Soft dollar and commission recapture	63,671	60,118	9,986	7,372	6,252
Payments for order flow and ECN rebates	21,220	36,632	32,179	36,306	52,482
Total transaction-based expenses	184,318	208,538	144,824	129,595	155,039
Revenues, net of transaction-based expenses	450,305	417,212	401,085	268,393	387,254
Other Direct Expenses					
Employee compensation and benefits	229,460	244,550	206,860	169,044	192,880
Communications and data processing	32,513	28,896	27,992	31,077	42,017
Professional fees	19,555	14,915	10,993	16,384	13,461
Depreciation and amortization	16,355	14,248	19,385	26,658	33,147
Occupancy and equipment rentals	13,554	16,852	17,449	21,554	21,290
Business development	6,419	8,269	7,160	6,852	9,580
Writedown of assets and lease loss accrual	10,055	3,810	16,508	15,423	17,658
Regulatory charges and related matters	5,703	79,342			
International charges				31,221	
Other	11,540	6,844	11,152	13,771	14,289
Total other direct expenses	345,154	417,726	317,499	331,984	344,322
Income (loss) before income taxes, minority interest and discontinued operations	105,151	(514)	83,586	(63,591)	42,932
Income tax expense (benefit)	38,912	9,258	32,497	(20,139)	21,813
Income (loss) before minority interest and discontinued operations	66,239	(9,772)	51,089	(43,452)	21,119
Minority interest in consolidated subsidiaries				5,101	6,477

Net income (loss) from continuing operations	$ 66,239	$ (9,772)	$ 51,089	$ (38,351)	$ 27,596
Income (loss) from discontinued operations, net of tax	$ 122	$ 100,904	$ (13,016)	$ (4,886)	$ 8,747
Net income (loss)	$ 66,361	$ 91,132	$ 38,073	$ (43,237)	$ 36,343
Basic earnings per share from continuing operations	$ 0.64	$ (0.09)	$ 0.46	$ (0.32)	$ 0.22
Diluted earnings per share from continuing operations	$ 0.62	$ (0.08)	$ 0.43	$ (0.32)	$ 0.22
Basic earnings per share from discontinued operations	$	$ 0.90	$ (0.12)	$ (0.04)	$ 0.07
Diluted earnings per share from discontinued operations	$	$ 0.86	$ (0.11)	$ (0.04)	$ 0.07
Basic earnings per share	$ 0.64	$ 0.81	$ 0.34	$ (0.36)	$ 0.29
Diluted earnings per share	$ 0.62	$ 0.77	$ 0.32	$ (0.36)	$ 0.29
Shares used in computation of basic earnings per share	103,455,791	112,423,158	112,023,419	120,771,786	123,796,181
Shares used in computation of diluted earnings per share	106,881,855	117,636,085	117,749,743	120,771,786	125,758,863

	December 31,				
	2005	2004	2003	2002	2001
Consolidated Statements of Financial Condition Data:					
Cash and cash equivalents	$ 230,591	$ 445,539	$ 249,998	$ 236,629	$ 344,553
Securities owned, held at clearing brokers, at market value	380,367	254,473	201,239	143,357	417,071
Investment in Deephaven sponsored funds	281,657	215,330	197,605	148,688	50,919
Assets within discontinued operations			2,938,223	2,411,285	1,928,946
Total assets	1,416,016	1,394,020	3,960,228	3,174,058	3,228,980
Securities sold, not yet purchased, at market value	345,457	221,421	173,119	84,715	343,908
Liabilities within discontinued operations			2,808,167	2,200,504	1,747,395
Total stockholders equity	823,448	851,202	787,096	753,832	831,667

(1) - Certain prior year amounts have been reclassified to conform to current year presentation.

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Item 7. ***Management s Discussion and Analysis of Financial Condition and Results of Operations***

Executive Overview

We are a leading financial services firm that provides comprehensive trade execution solutions and asset management services. We continually apply knowledge and innovation to the trading and asset management processes to build lasting client partnerships through consistent performance and superior client service. We have two operating business segments, Asset Management and Global Markets, as well as a Corporate segment.

Asset Management Our Asset Management business, Deephaven Capital Management, 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 of assets under management as of December 31, 2004.

Global Markets We provide 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 (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, 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

Consolidated revenues in 2005 increased $8.8 million, or 1% from 2004, while consolidated Operating Expenses decreased $29.5 million or 5% from 2004. Overall, Consolidated Pre-Tax Operating Earnings increased $38.3 million, or 46% from 2004, primarily attributable to gains on the sales of our strategic investments within our Corporate segment. The changes in our Pre-Tax Operating Earnings by our segments from 2004 to 2005 are summarized as follows:

Asset Management Our 2005 Pre-Tax Operating Earnings from Asset Management were down slightly from 2004, primarily due to the impact of higher profitability-based compensation and other operating expenses, offset by slightly higher blended fund returns.

Global Markets Our 2005 Pre-Tax Operating Earnings from Global Markets were down 35% from 2004, primarily due to greater competition for broker-dealer client order flow and reduced revenue capture metrics offset, in part, by decreased losses incurred from our expanded London operation.

Corporate The results from our Corporate segment were positively impacted by realized gains from the sales of our corporate equity investments in the International Securities Exchange, Inc. (ISE) and The Nasdaq Stock Market, Inc. (Nasdaq), as well as slightly higher returns on our corporate investment in the Deephaven Funds.

A reconciliation of 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 elsewhere in this section.

Certain Factors Affecting Results of Operations

We have experienced, and expect to continue to experience, significant fluctuations in operating results due to a variety of factors, including, but not limited to, introductions or enhancements to trade execution services by us or our competitors; the value of our securities positions and our ability to manage the risks attendant thereto; the volume of our market-making activities; the dollar value of securities traded; volatility in the securities markets; our market share with institutional and broker-dealer clients; the performance, amount of, and volatility in, the results of our quantitative market-making and program trading portfolios; the performance of our international operations; our ability to manage personnel, overhead and other expenses, including our occupancy expenses under our office leases and expenses and charges related to our legal and regulatory proceedings; the strength of our client relationships; changes in payments for order flow and clearing, execution and regulatory transaction costs; the level of assets under management and fund returns; the addition or loss of executive management and asset management, sales and trading and technology professionals; legislative, legal and regulatory changes; legal and regulatory matters; geopolitical risk; the amount and timing of capital expenditures, acquisitions and divestitures; the integration, performance and operation of acquired businesses; the incurrence of costs associated with acquisitions and dispositions; investor sentiment; technological changes and events; seasonality; competition and market and economic conditions. Such factors may also have an impact on our ability to achieve our strategic objectives, including, without limitation, increases in our institutional market share and revenue capture in our Global Markets segment and increases in our fund returns and assets under management in our Asset Management segment. If demand for our services declines in either of our segments due to any of the above factors, and we are unable to adjust our cost structure on a timely basis, our operating results and strategic objectives could be materially and adversely affected.

As a result of the foregoing factors, period-to-period comparisons of our revenues and operating results are not necessarily meaningful and such comparisons cannot be relied upon as indicators of future performance. There also can be no assurance that we will be able to return to the rates of revenue growth that we have experienced in the past or that we will be able to improve our operating results.

Trends

We believe that our continuing operations are currently impacted by the following trends that may affect our financial condition and results of operations.

Over the past several years, the effects of market structure changes, competition and market conditions have resulted in a decline in revenue capture per U.S. equity dollar value traded in our Global Markets operations.

Retail broker-dealer participation in the equity markets has fluctuated over the past few years due to investor sentiment, market conditions and a variety of other factors. Retail transaction volumes may not be sustainable and are not predictable.

Broker-dealer clients continue to focus on statistics measuring the quality of equity executions (including speed of executions and price improvement). In an effort to improve the quality of their executions as well as increase efficiencies, market-makers have increased the level of automation within their operations. The greater focus on execution quality has resulted in greater competition in the marketplace, which has negatively impacted the revenue capture metrics of the Company and other market-making firms.

Market structure changes, competition and market conditions have triggered an industry shift toward market-makers charging explicit commissions or commission equivalents to institutional clients for executions in OTC securities. For the majority of our institutional client orders, we currently charge explicit fees in the form of commissions or commission equivalents. In addition, institutional commission rates have fallen in the past few years, and may continue to fall in the future.

Due to regulatory scrutiny over the past several years relating to equity sell-side research and the continued focus by investors on execution quality and overall transaction costs, more institutional clients allocate commissions to broker-dealers based on the quality of executions. In the past, institutional equity commissions were primarily allocated to broker-dealers in exchange for either research or soft dollar and commission recapture programs.

There has been increased scrutiny of equity and option market-makers, hedge funds and soft dollar practices by the regulatory and legislative authorities. New legislation or modifications to existing regulations and rules could occur in the future.

There has been consolidation among market centers over the past year, and several regional exchanges have entered into joint ventures with broker-dealers to create their own alternative trading systems (i.e. ECNs) and compete within the OTC and listed trading venues.

There has been a proliferation of alternative investment entities, which has had the effect of materially increasing competition for new investor assets.

Income Statement Items

The following section briefly describes the key components of, and drivers to, our significant revenues and expenses.

Revenues

Our revenues consist principally of Commissions and fees and Net trading revenue from U.S. securities trading and market-making activities from Global Markets. Revenues on transactions for which we charge explicit commissions or commission equivalents, which include the majority of our institutional client orders, are included within Commissions and fees. Commissions and fees are primarily affected by changes in our equity transaction volumes with institutional clients, changes in commission rates, the growth of our soft dollar and commission recapture activity as well as by changes in fees earned for directing trades to certain destinations for execution and from certain market data providers.

Trading profits and losses on principal transactions are included within Net trading revenue. These revenues are primarily affected by changes in the amount and mix of U.S. equity trade and share volumes, our revenue capture, dollar value of equities traded, our ability to derive trading gains by taking proprietary positions, changes in our execution standards, volatility in the marketplace, industry commission levels, our mix of broker-dealer and institutional clients, and regulatory changes and evolving industry customs and practices.

Asset management fees represent fees earned by Deephaven for sponsoring and managing the Deephaven Funds. These fees 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.

We earn interest income from our cash held at banks and cash held in trading accounts at clearing brokers. The Company s clearing agreements call for payment or receipt of interest income, net of transaction-related interest charged by clearing brokers for facilitating the settlement and financing of securities transactions. Net interest is primarily affected by interest rates, the changes in cash balances held at banks and clearing brokers and our level of securities positions in which we are long compared to our securities positions in which we are short.

Investment income and other income primarily represents income earned, net of losses, related to our corporate investment in the Deephaven Funds and our strategic investments. Such income is primarily affected by the level of our corporate investments in our Deephaven Funds and rates of return earned by the Deephaven Funds as well as the performance and activity of our strategic investments.

Transaction-based expenses

Transaction-based expenses include transaction-based variable expenses directly incurred in conjunction with generating revenues and consist of Execution and clearance fees, Soft dollar and commission recapture expense, and Payments for order flow and ECN rebates.

Execution and clearance fees primarily represent clearance fees paid to clearing brokers for equities transactions, transaction fees paid to Nasdaq and other exchanges and regulatory bodies, and execution fees paid to third parties, primarily for executing trades in listed securities on the New York Stock Exchange (NYSE) and American Stock Exchange (AMEX), and for executing orders through third party ECNs. Execution and clearance fees primarily fluctuate based on changes in equity trade and share volume, clearance fees charged by clearing brokers and fees paid to access ECNs, exchanges and certain regulatory bodies.

Soft dollar and commission recapture expense represent payments to institutions in connection with our soft dollar and commission recapture programs. Soft dollar and commission recapture expense fluctuates based on U.S. equity share volume executed on behalf of institutions.

Payments for order flow and ECN rebates represent payments to broker-dealer clients, in the normal course of business, for directing to us their order flow in U.S. equities and rebates for providing liquidity to our ECN, Direct Edge. Payments for order flow and ECN rebates fluctuate as we modify our rates and as our percentage of clients whose policy is not to accept payments for order flow varies. Payments for order flow and ECN rebates also fluctuate based on U.S. equity share volume, our profitability and the mix of market orders and limit orders.

Other direct expenses

Other direct expenses mostly consist of Employee compensation and benefits, Communications and data processing, Professional fees, Depreciation and amortization and Occupancy and equipment rentals.

Employee compensation and benefits expense, our largest expense, primarily consists of salaries and wages paid to all employees and profitability-based compensation, which includes compensation paid to sales personnel and incentive compensation paid to all other employees based on our overall profitability. Compensation for

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employees engaged in sales activities is determined primarily based on a percentage of their gross revenues net of certain expenses including soft dollar and commission recapture expenses, execution and clearance costs and overhead allocations. The majority of compensation in Asset Management is determined based on a profitability-based formula, subject to certain minimum guaranteed payments. Employee compensation and benefits expense fluctuates, for the most part, based on changes in our revenues, profitability and the number of employees.

Communications and data processing expense primarily consists of costs for obtaining market data, telecommunications services and systems maintenance.

Results of Operations

The following table sets forth the consolidated statements of operations data as a percentage of total revenues:

	For the years ended December 31,		
	2005	2004	2003
Revenues			
Commissions and fees	46.7%	44.1%	29.9%
Net trading revenue	26.1%	40.1%	53.3%
Asset management fees	14.1%	12.4%	10.6%
Interest and dividends, net	1.4%	0.8%	0.7%
Investment income and other	11.7%	2.6%	5.5%
Total revenues	100.0%	100.0%	100.0%
Transaction-based expenses			
Execution and clearance fees	15.7%	17.9%	18.8%
Soft dollar and commission recapture expense	10.0%	9.6%	1.8%
Payments for order flow and ECN rebates	3.3%	5.9%	5.9%
Total transaction-based expenses	29.0%	33.3%	26.5%
Revenues, net of transaction-based expenses	71.0%	66.7%	73.5%
Other direct expenses			
Employee compensation and benefits	36.2%	39.1%	37.9%
Communications and data processing	5.1%	4.6%	5.1%
Professional fees	3.1%	2.4%	2.0%
Depreciation and amortization	2.6%	2.3%	3.6%
Occupancy and equipment rentals	2.1%	2.7%	3.2%
Business development	1.0%	1.3%	1.3%
Writedown of assets and lease loss accrual	1.6%	0.6%	3.1%
Regulatory charges and related matters	0.9%	12.7%	0.0%
Other	1.8%	1.1%	2.1%
Total other direct expenses	54.4%	66.8%	58.2%

Income (loss) from continuing operations before income taxes	16.6%	0.1%	15.3%
Income tax expense	6.1%	1.5%	6.0%
Net income (loss) from continuing operations	10.5%	1.6%	9.4%
Income (loss) from discontinued operations, net of tax	0.0%	16.1%	2.3%
Net income	10.5%	14.6%	7.0%